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 December 2004
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Republic of Armenia: 2004 Article IV Consultation, Sixth Review Under the Poverty Reduction and Growth Facility, and Request for Waiver of Performance Criteria—Staff Report; Staff Statement; and Public Information Notice and Press Release on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2004 Article IV consultation with the Republic of Armenia and sixth review under the Poverty Reduction and Growth Facility, and request for a waiver of performance criteria, the following documents have been released and are included in this package:

- the staff report for the combined 2004 consultation, sixth review under the Poverty Reduction and Growth Facility, and request for waiver of performance criteria, prepared by a staff team of the IMF, following discussions that ended on September 9, 2004, with the officials of the Republic of Armenia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 17, 2004. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of December 1, 2004 updating information on recent economic developments.

- a Public Information Notice (PIN) and Press Release, summarizing the views of the Executive Board as expressed during the December 1, 2004 Executive Board discussion of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of the Republic of Armenia*
Memorandum of Economic Policies by the authorities of the Republic of Armenia*
Ex Post Assessment of Long-Term Program Engagement

*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF ARMENIA

Staff Report for the 2004 Article IV Consultation, Sixth Review Under the Poverty Reduction and Growth Facility, and Request for Waiver of Performance Criteria

Prepared by the Middle East and Central Asia Department
(In consultation with other departments)

Approved by Lorenzo Pérez and Martin Fetherston

November 17, 2004

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EXECUTIVE SUMMARY

Armenia's economy has performed well during the last three years. Prudent financial policies, structural reforms, and external financial support contributed to double-digit economic growth, low inflation, declining fiscal, quasi-fiscal, and external imbalances, and poverty reduction. Most targets under the PRGF-supported program were met, although some structural reforms suffered from delays or deficient implementation. The program was closely aligned with the Poverty Reduction Strategy Paper (PRSP).

The discussions focused on policies to sustain growth and foster poverty reduction, which are the key challenges ahead. Future policies entail a deepening of structural reforms to revamp tax and customs administration, strengthen the financial sector and the judiciary, and improve expenditure management. While important reforms have taken place in the energy and water sectors, the reform agenda should be completed with the support of the World Bank.

- The stance of monetary policy is in line with the authorities' 3-percent inflation objective. The staff encouraged the authorities to deepen the market for government bonds to facilitate monetary management and eventual private debt issues.

- Armenia's flexible trade and exchange rate regimes have served the country well. The recent appreciation of the dram is offsetting the effect of higher import prices and is compatible with large productivity gains in tradable sectors since 2001.

- The 2005 budget is expected to maintain a prudent fiscal stance and align expenditures with PRSP priorities on infrastructure outlays. A fiscal deficit slightly above 2 percent of GDP is consistent with economic stability and with increases in social and infrastructure spending. The authorities need to monitor the effectiveness of expenditures and increase capacity and accountability in state-owned noncommercial organizations.

- There is a need to revamp the tax and customs administration agencies to boost efficiency and reduce discretion, especially by making wide use of risk-based audit systems for collection, VAT refunds, and customs clearance. The staff has also advised the authorities to revisit the organizational structure of the tax and customs agencies and bring them under the control of the Ministry of Finance.

- The recent strengthening of the banking system and growth in private sector credit are promising developments. Remaining reforms involve enhancing corporate governance, streamlining collateral recovery procedures, and improving court processes.

- To tackle lingering governance problems, the implementation of the recently prepared anti-corruption strategy should be stepped up and complemented with appropriate penalties for abuse and with an efficient and independent judicial system.

Armenia has made substantial progress in setting up the basic framework for sound macroeconomic policies and the makings of a modern market economy. The implementation of the narrow set of recent or remaining reforms requires, however, a higher degree of political commitment. Such resolve will be critical for the success of an eventual successor program that could be supported by the Fund.

I. INTRODUCTION

1. Discussions on the 2004 Article IV consultation and the sixth review under the Poverty Reduction and Growth Facility (PRGF) were held in Yerevan from August 26 to September 9, 2004.[1] Armenia's three-year PRGF arrangement for SDR 69 million (75 percent of quota) was approved on May 23, 2001 (IMF Country Report No. 02/73). The equivalent of SDR 60 million has been disbursed, and the equivalent of SDR 9 million will be available upon completion of this review (Table 1). The arrangement expires on December 31, 2004.

2. The thrust of the Fund's policy advice in previous Article IV consultations has been broadly implemented, especially in the areas of macroeconomic stabilization and quasi-fiscal reforms. In concluding the 2002 Article IV consultation on September 25, 2002 (Armenia is on a 24-month consultation cycle), Directors commended the authorities for their success in maintaining macroeconomic stability and welcomed the envisaged reduction in the fiscal deficit. They expressed concern that there had been slippages in the implementation of key structural policies and emphasized the importance of improving tax administration, clearing budgetary arrears, and pursuing reforms to restructure the banking system and improve performance in the energy and water sectors. Most recommendations made in the context of the Article IV consultation overlapped with conditionality in the PRGF-supported program (Appendix I).

3. Given Armenia's long-term program engagement with the Fund, the staff has prepared an ex post assessment of past involvement.[2] The assessment concludes that Armenia's engagement with the Fund has been beneficial to policymaking and has facilitated access to external financing.[3] The authorities have expressed interest in continued Fund support through a successor PRGF arrangement. In the attached Letter of Intent (Attachment I), the authorities request the completion of the sixth review and a waiver for the nonobservance of end-July 2004 energy sector performance criteria. In the accompanying Memorandum of Economic Policies (Attachment II), the authorities describe a set of policies designed to maintain the reform momentum in coming months.

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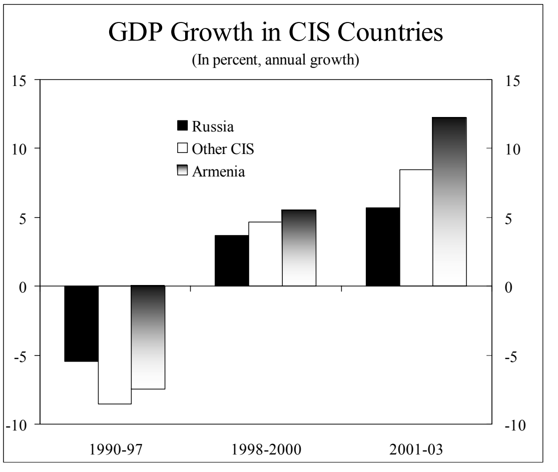
[1] The staff representatives met with the Prime Minister, Mr. Margaryan; the Minister of Finance and Economy, Mr. Khachatryan; the Chairman of the Central Bank, Mr. Sargsyan; the Economic Advisor to the President, Mr. Nercissantz, the Minister of Foreign Affairs, Mr. Oskanian; the Minister of Justice, Mr. Haroutyunian; other senior officials; and representatives of nongovernmental organizations, the donor community, and the private sector. The staff team comprised Mr. Gelbard (head), Ms. George, Mr. McHugh (Resident Representative), and Mr. Beddies (all MCD); Ms. Redifer (PDR); Mr. Bhatia (MFD); and Mr. Simone (FAD). Ms. Minasyan and Mr. Stepanyan (economists at the local office) provided valuable support. Mr. Christiansen (head of the ex post assessment team) conducted discussions on the assessment of performance under Fund-supported programs on September 13.

[2] The report on the ex post assessment has been distributed to the Executive Board.

[3] A summary of Armenia's relations with the Fund, including technical assistance provided and assessments of standards and codes, is presented in Appendix II. Armenia's structural reform agenda is also supported by the World Bank Group (Appendix III), the European Bank for Reconstruction and Development (Appendix IV), and bilateral donors.

II. Stocktaking of Performance in Recent Years

4. **Armenia is reaping the benefits of a decade of reforms.** After an initial sharp contraction of output in the early 1990s, the policy path on which Armenia embarked since the mid-1990s created a stable economic environment and the conditions for a resumption of economic growth and poverty reduction. Real economic growth averaged 9 percent over the past 6 years in a low inflation environment, and real per capita income stands now at more than twice its 1997 level.



5. **Notwithstanding these achievements, progress was not smooth and a number of challenges remain.** Political instability and indecision in the government during the period 1999–2001 led to a slowdown of the reform momentum and of economic activity. The situation has improved since 2001 and the country has enjoyed unprecedented levels of investment and foreign financing (including support from the Armenian diaspora). Nevertheless, Armenia's reform agenda remains to be finished, poverty is high, and trade prospects are crippled because of unresolved disputes with Turkey and Azerbaijan.[4]

6. **The PRGF-supported program has focused on measures necessary for sustained macroeconomic stability and a deepening of structural reforms.** The program aimed at reducing the fiscal and quasi-fiscal deficits, repaying domestic and foreign arrears, lowering debt ratios, and running a cautious monetary policy in a flexible exchange rate environment. The structural reform agenda was geared to support stabilization efforts, reduce vulnerabilities, and sustain medium-term growth prospects. It focused on improving the business environment, strengthening the banking system, tax and customs administration, and expenditure management, as well as increasing efficiency in the energy and water sectors (Appendix I).

7. **The program has been consistent with Armenia's PRSP**.[5] The policies and programs envisaged in the PRSP have been progressively integrated into the Medium-Term Expenditure Framework (MTEF) and the budget process. The authorities have changed expenditure priorities in the budget, implemented reforms in the areas of health and education, and proceeded to develop monitoring indicators.[6] They have also been refocusing their efforts on social policies and the rural economy.

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[4] The accompanying Selected Issues paper contains an assessment of Armenia's reforms and future challenges.

[5] An interim PRSP was prepared in March 2001, and the full PRSP was finalized in September 2003 (IMF Country Report No. 03/362).

[6] In October 2004, the authorities prepared a draft Annual Progress Report of PRSP implementation. The draft outlines the policies adopted during the last year, including the additional allocations for poverty-reducing

8. **The policies supported by the program have been remarkably successful on the macroeconomic front.** Annual real GDP growth averaged 12 percent between 2001 and 2003 and poverty rates fell. Growth, fueled by grant and privately financed investment and exports, was broad-based. The external current account deficit fell in response to strong export growth and import substitution. The pattern and the geographical composition of trade also changed, with trade flows shifting away from the Commonwealth of Independent States (CIS) and into European Union countries. Fiscal and quasi-fiscal deficits were significantly reduced and inflation remained in single digits. In addition, competitiveness and debt ratios improved markedly.

Armenia: Main Economic Indicators, 1998–2003

(In percent of GDP, unless otherwise indicated)

	1998–2000 (average)	2001	2002	2003
Real GDP growth (in percent)	5.5	9.6	13.2	13.9
Investment	19.1	19.8	21.7	24.7
Inflation (average, in percent)	2.8	3.1	1.1	4.8
General government balance (commitment basis)	-6.4	-3.7	-0.3	-1.1
Quasi-fiscal (energy and water) balances	-5.0	-4.6	-2.7	-1.5
External current account	-17.8	-9.5	-6.2	-6.8
Debt-to-exports ratio	147	132	131	87
Poverty rate 1/	55	51	49	43

Sources: Armenian authorities; and Fund staff estimates.

1/ Percent of population. The data in the first column correspond to the 1998/99 household survey results. The data for 2003 are preliminary.

9. **However, tax revenue performance has been disappointing.** While tax revenues increased rapidly in both real and nominal terms since 2000, they have not fared well as a share of GDP. Four factors affected tax revenues in recent years: (i) income tax rates were reduced in 2000; (ii) profit tax holidays were granted to large foreign investments;[7] (iii) part of the increase in economic activity during 2002-03 was financed with foreign grants and loans in activities that are not taxed because of international agreements; and (iv) tax and customs administration did not improve sufficiently.

Armenia: Tax-to-GDP Ratios

(In percent of GDP, unless otherwise noted)

	2000	2001	2002	2003
Tax revenue (central government)	14.8	14.3	14.6	14.0
of which: VAT	6.5	6.7	7.0	6.6
Profit tax	2.0	1.3	1.3	1.1
Income tax	1.3	0.9	0.9	1.0
Memorandum Items:				
Nominal tax revenue growth (in percent)	-4.0	10.5	17.9	14.5
Real tax revenue growth (in percent) 1/	-7.0	6.3	15.1	9.5

1/ Deflated by the GDP deflator

2/ The tax base is estimated as GDP minus 90 percent of the value-added in construction which is largely tax-exempt due to international agreements with donors.

10. **Most of the envisaged structural reforms were carried out, but some suffered from delays and weak implementation.** There was good progress in strengthening expenditure control, reducing red tape, and improving efficiency in the energy and water sectors. By mid-2004, EBRD transition indicators showed that Armenia fared quite well compared to other CIS countries on all dimensions of structural reforms. Still, this positive assessment is tempered by some delays and weak implementation. For instance, there have

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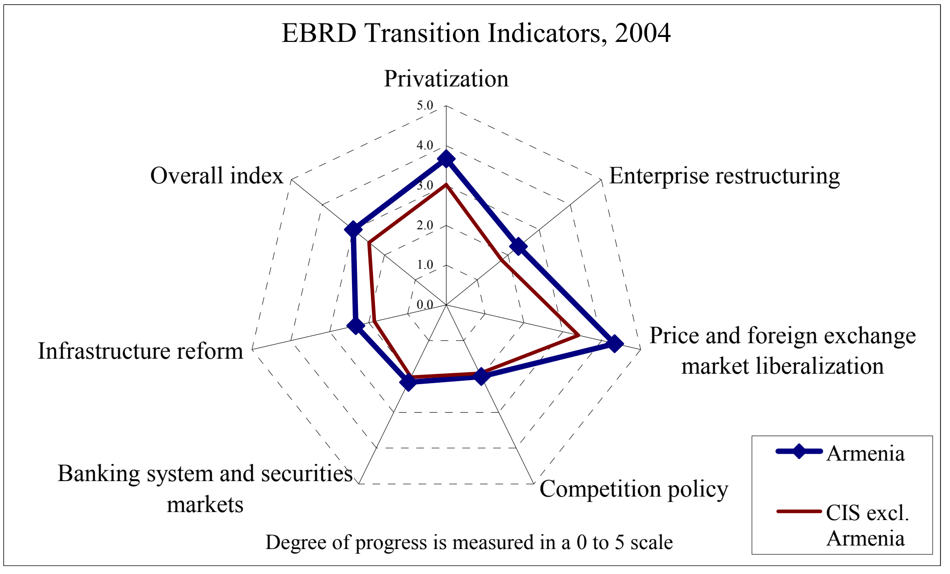
expenditures and the improvement in poverty indicators. The authorities are expected to finalize the draft by end-November, after which the staffs will proceed to prepare the corresponding Joint Staff Advisory Note.

[7] It is estimated that lower taxes and profit tax exemptions caused a revenue loss of 1.3 percent of GDP.

been delays in the resolution of problem banks, and the actual implementation of tax and customs administration reforms have been insufficient to bring about the intended results.[8]



III. Recent Developments

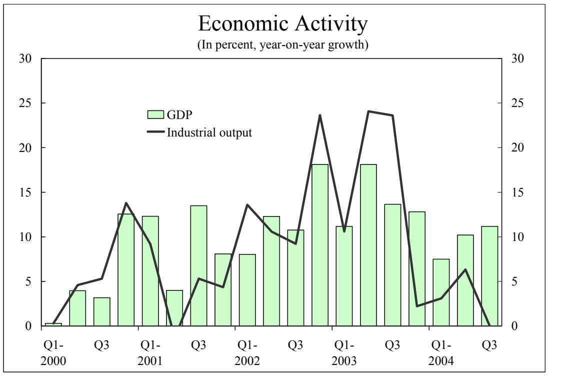
11. The **political situation** is stable but the influence of vested interests is a concern. The government coalition remains firmly in control following anti-government demonstrations in April. At that time, the opposition contested the legitimacy of President Kocharian's re-election in 2003. More recently, the increasing influence of vested interests in parliament led to the stalling of pieces of tax legislation and the granting of tax privileges.[9] These developments are worrisome as they put the country's prospects for lasting reform at risk. On the international arena, the European Union has recently included Armenia in the configuration of the "wider Europe" initiative, an event that in the long term could foster economic integration and contribute to a diplomatic solution to the Nagorno-Karabakh conflict.[10] The latter, however, cannot be easily resolved because of deep-rooted sensitivities in both Armenia and Azerbaijan.

[8] This reflected choices made by the authorities (e.g., prolonged period of intervention of commercial banks) as well as the influence of vested interests and capacity constraints (e.g., discretion and inefficiency in tax and customs administration).

[9] As in other countries of the former Soviet Union, powerful business interests have emerged in the transition to a market economy. These interests have been exerting influence in the media, parliament, and in government decisions. NGOs have also been vocal about this issue as well as corruption in general.

[10] In mid-June, the EU included Armenia, Georgia, and Azerbaijan in the European Neighborhood Policy with the aim of promoting stability in the region.

12. Armenia's strong **macroeconomic performance** has continued in 2004. In the period January-September, the year-on-year rate of GDP growth was 10 percent. The growth momentum has been maintained despite a reduction in external private grants, fueled by increases in agricultural production, housing construction, and services. GDP growth for the year as a whole is projected at 9 percent (Table 2). The 12-month rate of inflation fell from 8.6 percent in December 2003 to 6.1 percent in September. The central bank's inflation objective of 3 percent for 2004 is within reach, although it may be exceeded slightly because of recent increases in the price of imported fuels.



13. **Poverty and income inequality** have been falling, but they still remain high. The improvements are much smaller in cities other than Yerevan and in rural areas. The overall poverty rate fell from 51 percent in 2001 to an estimated 43 percent in 2003.[11] Gini coefficients of inequality also fell during the same period. Health and education services have improved gradually, but remain below standard. The rural infrastructure, especially roads and water supply, remains deficient. Looking ahead, and assuming implementation of the policies envisaged in the PRSP, Armenia is well positioned to achieve most of the Millennium Development Goals by 2015 (Table 3).

Armenia: Poverty and Inequality, 1999–2003
(Percent of total population, unless otherwise noted)

	1999	2001	2003 1/
Overall poverty rate	55	51	43
of which: Rural poverty	51	49	48
Extreme poverty	23	16	8
Gini coefficient (income) 2/	0.59	0.53	0.44
Gini coefficient (consumption) 2/	0.37	0.34	0.27

Source: Armenian authorities; based on data from Household Surveys.
1/ Preliminary estimates.
2/ Ranges from 0 (perfect equality) to 1 (total inequality).

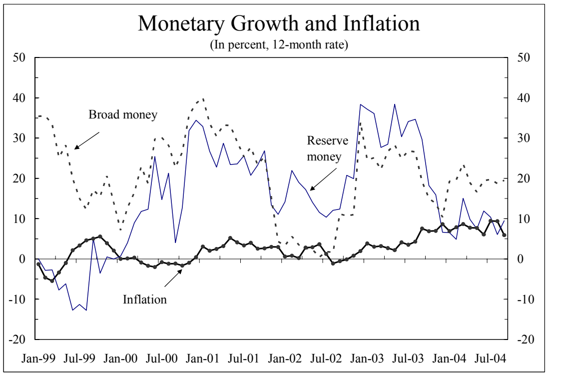
14. **Fiscal policy** has remained prudent, with somewhat higher-than-programmed tax revenues and lower-than-programmed expenditures. Tax revenues through September 2004 increased by 21 percent over the same period last year.[12] In June, Parliament approved a supplementary budget allocation entailing an increase in expenditures of 0.7 percent of GDP. The higher expenditures focus on priority capital expenditures and will be executed during a 12-month period. Notwithstanding the additional allocation, the fiscal deficit is projected at 1.3 percent of GDP in 2004 because of under-execution of expenditures (Table 4). The under-execution reflects a combination of factors, including optimistic assumptions about the timing for implementation of donor-financed projects and capacity constraints.[13]

[11] The 2003 figures are preliminary estimates from the authorities. World Bank staff estimates that poverty and inequality have fallen even further.

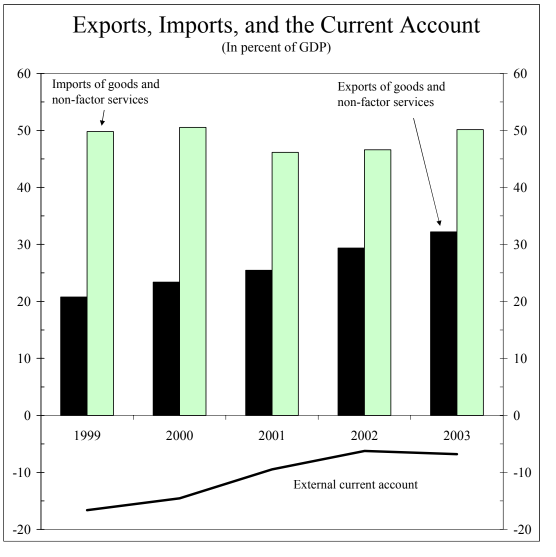
[12] The tax-to-GDP ratio, however, may not improve as expected in 2004 if growth and/or the GDP deflator turn out to be higher than projected.

[13] The execution of current expenditures has improved in 2004, but problems remain regarding the execution of capital expenditures. The authorities indicated that they expect an improvement in 2005.

15. **Monetary policy** has also been prudent. Money demand has been increasing in light of strong economic activity and improved confidence in the banking system. In 2004, reserve money and broad money are projected to grow at about 4 percent and 15 percent, respectively (Table 5).



16. The **external current account balance and debt ratios** are improving. After a slight deterioration in 2003, the current account deficit is expected to narrow to 5.6 percent of GDP in 2004 because of higher workers' remittances.[14] Both import and export growth will be lower this year than in 2003, as last year's grant-induced surge in imports dissipates and diamond export growth is hindered by increased competition from other countries. Despite lower capital grants, the capital and financial account remain well supported by continued increases in foreign investment. Gross international reserves are expected to remain slightly below four months of imports. Lastly, Armenia's debt management strategy during the last two years has been successful, and external debt ratios are projected to decline further in 2004–05 (Table 6).[15]



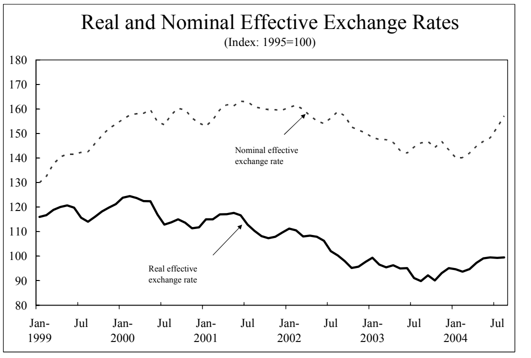
17. **Flexible trade and exchange regimes have served Armenia well in recent years.**[16] Since late 2003, strong capital inflows and higher remittances have contributed to an appreciation of the dram. In the 12-months to August 2004, the real exchange rate appreciated by 11 percent, helping to mitigate the effect of recent hikes in the prices of imported fuels on inflation and on real income. The appreciation does not pose a threat to

[14] According to official statistics, worker remittances (private transfers and worker compensation inflows) are equivalent to 8 percent of GDP, but unofficial estimates point to a figure between 15 and 25 percent of GDP.

[15] During 2002-03, external financing contained a balanced mix of grants and concessional borrowing, and domestic debt issuance was limited. Payment arrears were cleared in 2003, and debt-for-equity swaps lowered the stock of external debt. Armenia has an excellent record of servicing its obligations to the Fund.

[16] The exchange rate fluctuates in response to market forces, although the central bank intervenes occasionally in the foreign exchange market to smooth out volatility. Armenia accepted the obligations under Article VIII, Sections 2(a), 3, and 4 of the Fund's Articles of Agreement in 1992 and maintains an exchange system free of restrictions on payments and transfers for current international transactions, except for exchange restrictions kept for security reasons.

export competitiveness because (i) the real exchange rate had depreciated by more than 25 percent between 2000 and 2003 and (ii) productivity gains are boosting exports and real wages and are thus compatible with the recent real appreciation.[17]

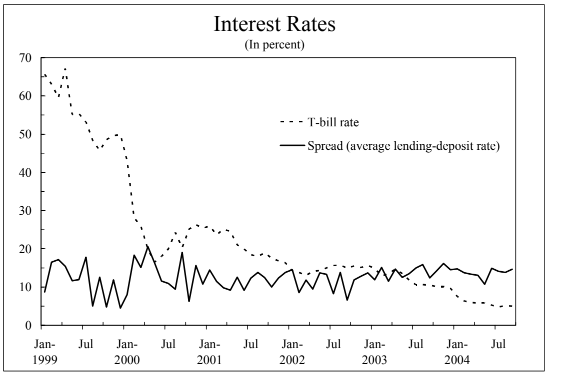


18. **Banking sector performance** has improved, especially during the last year, and there has been a gradual return of confidence toward banks following the resolution of eight banks that had been intervened by the government (Table 7). The last intervened institution to be resolved, Armcommunications Bank, was recapitalized by a new investor in October 2004.[18] Since mid-2003, monetization has been rising, the currency-to-deposits ratio has been falling, and interest rates have continued their gradual declining trend. Private sector credit grew by 43 percent in the year through September, albeit from a low base. However, dollarization (measured by the ratio of foreign currency deposits to total deposits) remains at over 70 percent. Overall, banking system soundness has improved, although weak corporate governance and the prevalence of foreign currency lending to unhedged borrowers are a concern (Box 1).

Armenia: Selected Banking System Indicators, 2000–04
(End of period; in percent)

	2000-01	2002	2003	Sept. 2004
Capital adequacy 1/	19.3	30.5	33.8	33.7
Nonperforming loans/gross loans	20.5	12.3	9.8	7.0
Liquidity 2/	31.8	44.5	47.5	47.6
Profits 3/	-5.5	3.9	2.7	3.2

Source: Central Bank of Armenia.
1/ Regulatory capital to risk-weighted assets.
2/ Liquid assets to total assets.
3/ Profits to period average assets.



19. **Recent performance under the PRGF-supported program** has been broadly satisfactory. The authorities met all the quantitative performance criteria for end-June 2004 (Table 8). The indicative target on the primary balance of the energy sector was missed by a small margin because of lower-than-expected collection from export sales. Regarding the implementation of structural reform measures, the energy sector structural performance criteria as well as two of the four structural benchmarks were delayed (Table 9).

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[17] The staff estimates that total factor productivity grew at an average rate of 9.4 percent per year between 2001and 2004 (see Section II of the accompanying Selected Issues paper).

[18] The staff is awaiting further information from the authorities on the details of this operation.

Box 1. Armenia: Financial Sector Soundness and Pending Reforms

Confidence in the banking sector is growing. Following the prolonged phase of bank exits and with bank supervision now strengthened, years of sluggish intermediation have given way to estimated annual growth rates of bank deposits and credit to the private sector of 28 percent and 43 percent, respectively, through September 2004. The latter was driven by consumer lending. Since end-2000, deposit dollarization has fallen by 5 percentage points to 76 percent and loan dollarization by 10 percentage points to 68 percent.

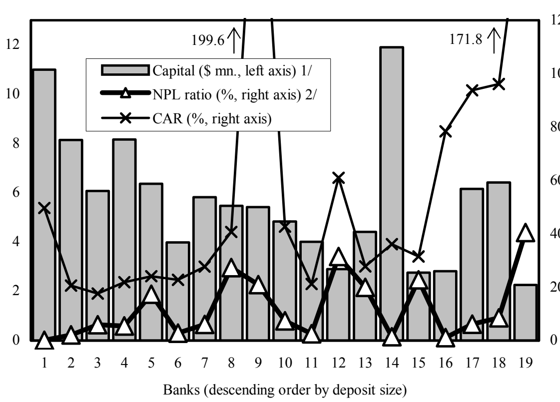
Further consolidation is likely. Currently there are 19 banks in Armenia-- arguably too large a number considering that total bank assets and broad money are equivalent to 19 percent and 14 percent of GDP, respectively. About four banks are likely to fall short of meeting the new minimum capital requirement of $5 million that becomes effective in mid-2005; this will likely lead to further consolidation (Chart A). Given that the niche players add little to the system, weeding out a few more small banks would be a positive development.

In the event of adverse shocks, capital cushions could prove inadequate for some banks. Partly reflecting the prevalence of dollar lending to un-hedged borrowers, nonperforming loan (NPL) ratios have been large and volatile, prompting banks to maintain generous capital buffers (Chart A). With large exposures having traditionally been twice as problematic as small exposures, the new emphasis on consumer lending may augur well for asset quality. The staff has run a credit risk stress test in which: (i) each bank's largest single customer exposure is assumed to go bad; and (ii) a varying percentage of other standard loans is assumed to migrate to the loss category (Chart B). The results indicate that the largest-customer failure plus a 10 percent loan migration as described above would cause four banks to fall below the minimum required CAR of 12 percent, including three banks that account for about 10 percent of the deposit base each.

A Financial Sector Assessment Program (FSAP) update planned for early 2005 will look at future reforms. Key areas will include: (i) corporate governance in both the banking and the non-financial sectors; (ii) financial reporting by companies to facilitate a shift away from collateral-based lending; (iii) bank supervision and bank resolution techniques; and (iv) transparency and efficiency in the judicial system. In parallel, the authorities are seeking to attract a second international bank in order to increase competition and bring new technologies into the system.

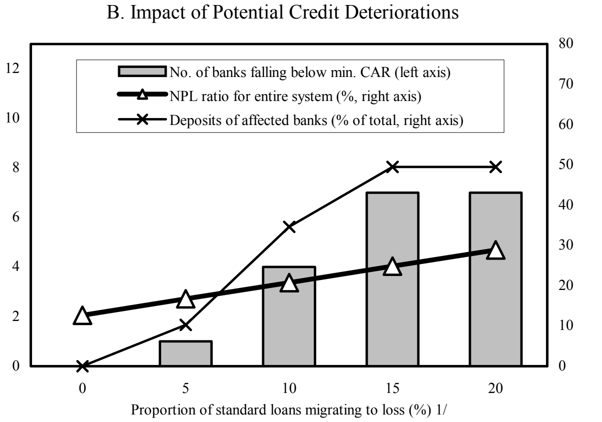
Armenia: Selected Stress Test Data and Results
(Based on July 2004 data)

A. Bank-by-Bank Capital, NPLs, and CARs



Source: CBA.
1/ At end-2003 exchange rate.
2/ Substandard, doubtful, and loss loans as a proportion of total gross loans.

B. Impact of Potential Credit Deteriorations



Source: Fund staff estimates.
1/ Over and above each bank's largest single customer exposure, all of which are assumed as *a priori* losses.

The performance criteria on the adoption of regulations for contracting electricity and removing the state-owned company Armenergo from the energy sector were implemented in October. The design of the regulations to enable direct contracting took longer than expected, which in turn delayed the decision on Armenergo.[19] The structural benchmark on the initiation of a VAT deferral system for capital goods was implemented in September while the one on the system of tax audits is expected to be implemented in November.[20]

IV. Report on the Discussions

20. The discussions focused on: (i) performance under the program and the ex post assessment of Armenia's long-term use of Fund resources (EPA); (ii) economic policies for the near-term; (iii) macro-relevant structural measures to sustain growth and foster poverty reduction, which are the key challenges ahead; and (iv) the medium-term economic outlook.

A. Ex Post Assessment and Review Discussions

21. **Since 1994, the Fund has provided almost continuous financial assistance to Armenia.** Given Armenia's long-term program engagement with the Fund, and considering that the current three-year PRGF arrangement (2001–04) is coming to an end, the staff has prepared an ex post assessment (EPA) of Fund involvement in the country. On balance, the EPA views the engagement positively and provides useful insights on the way forward (Box 2).

22. **The authorities were in broad agreement with the conclusions and recommendations of the ex post assessment.** They stressed that Fund-supported programs helped promote internal dialogue as well as structured and effective policy implementation. The authorities acknowledged that implementation of some structural measures—in particular those pertaining to the energy sector and tax and customs administration—suffered from delays and/or deficient implementation. They attributed these problems to the role of vested interests in resisting reforms and undermining program ownership. Nonetheless, the authorities stressed that slow progress in raising the tax-to-GDP ratio also stemmed from strong growth in tax-exempted sectors and that those exemptions were fostering growth or resulted from agreements with foreign donors.

[19] Armenergo was in charge of wholesale operations in the midstream sector. The staff had urged the authorities to liquidate Armenergo because of concerns about the quality of its management and its role in generating quasi-fiscal losses and distorting the electricity market. The decision on Armenergo reflects the fact that market rules were needed before the company could cease to intermediate transactions in the sector. The authorities are requesting a waiver for the nonobservance of these performance criteria.

[20] Drafts of a new audit manual and audit reform legislation have already been prepared.

Box 2. Assessment of Longer-Term Program Engagement: Key Points and Lessons

The Fund engagement with Armenia since 1994 has been beneficial. The country's economic performance compares favorably with similar countries in the region and the record of implementation of reforms is satisfactory. Program design and conditionality were on balance appropriate and many program objectives were met. Implementation was not without slippages, however, particularly during the 1999–2001 period.

The different programs helped to establish macroeconomic stability, reform key quasi-fiscal sectors, and set the stage for the development of an efficient treasury and a more stable banking system. Nonetheless, efforts to develop a well-functioning tax system and foster financial intermediation have been less successful, highlighting the need for increased ownership in these areas.

The main conclusions from the assessment are as follows:

- A higher degree of political commitment is required to address pending problems in the areas of tax and customs administration, the banking system, and governance in general.
- Continued Fund engagement would be beneficial and facilitate political support to consolidate the reform process, although lower financing needs point to a low-access type of arrangement.
- A successor arrangement could continue to provide a useful signaling role, build further capacity, and address remaining reforms in the areas of Fund competency.
- An eventual new program should target macro-critical areas and seek evidence of strong commitment to carry out the remaining reforms.
- An exit from PRGF support is envisaged after a potential successor arrangement. During the next three years, Armenia's income level is likely to exceed International Development Association (IDA) thresholds, the financing gap will probably diminish, and the reform agenda in the areas of Fund competence should be completed.

23. **Looking ahead, the authorities expressed interest in a successor arrangement.** The ex post assessment suggests a low-access PRGF, but the most recent balance of payments projections point to somewhat higher financing needs (Table 6).[21] The authorities expressed reservations about the suggestion in the ex post assessment that a hiatus between the present program and a successor PRGF-arrangement may be needed to ensure enough ownership of the remaining reform agenda. As the reform momentum slowed down earlier this year, the staff pointed out the risks of complacency and urged the authorities to put the common good above the influence of vested interests. Recognizing the need to demonstrate greater commitment to reform in certain areas, the authorities expressed their determination to invigorate the reform agenda in the coming months (Attachments I and II).

[21] The level of access would be determined at the appropriate time taking account of updated projections for external financing.

B. Near-Term Economic Policies

Fiscal policy

24. **The staff advised the authorities to maintain a balance between current and capital expenditures in the 2005 budget.** While the authorities' MTEF for 2005–07 targets a prudent fiscal deficit of 2 percent of GDP, it envisages sizable increases in current expenditures (including social expenditures), and much smaller increases in capital expenditures. The staff urged the authorities to rebalance budget priorities and allocate additional capital expenditures to PRSP priorities such as transport, agriculture, water, and housing. At the same time, the staff suggested that some current expenditure could be rationalized, and recommended that the pace of increase in current social spending could usefully be tied to improvements in capacity, efficiency, and transparency in the respective sectors.

25. **Understandings were reached on a budget framework for 2005, which is broadly in line with the PRSP.** On the revenue side, tax revenues are targeted to increase by at least 0.4 percent of GDP based on forthcoming tax reforms (see Section C below).[22] This increase, while appearing optimistic when compared to past outcomes, seems feasible given the sizable slack in tax administration. On the expenditure side, some savings are envisaged in domestic interest payments and subsidies, while current expenditures on health, education, and social security are projected to increase by 1 percent of GDP (Table 10). The latter are broadly in line with the amounts envisaged in the PRSP. Regarding capital expenditures, domestically-financed capital expenditures are expected to increase by about 0.6 percent of GDP (Table 4). In addition to foreign-financed concessional projects, the authorities expect confirmation on additional financing from the Millennium Challenge Account (MCA) in early 2005 and will then reflect the respective amounts in the budget.[23]

Armenia: Selected Fiscal Indicators, 2002–05
(Central Government, in percent of GDP)

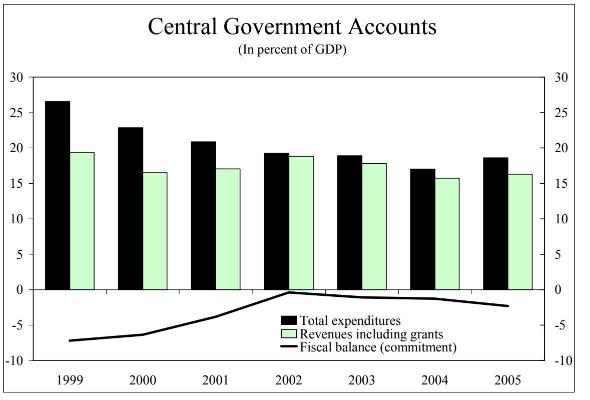
	2002	2003	2004 Rev. Prog.	2005 Proj.
Total revenue and grants	18.8	17.8	15.7	16.3
of which : tax revenue	14.6	14.0	14.4	14.9
grants	3.5	3.2	0.9	1.0
Total expenditure	19.3	18.9	17.0	18.6
Current expenditure	13.9	12.8	13.2	14.2
Capital expenditure and net lending	5.4	6.1	3.8	4.4
Overall balance (commitment basis)	-0.4	-1.1	-1.3	-2.3
Overall balance (cash basis)	-2.6	-1.5	-1.3	-2.3
Memorandum item:				
Social expenditure	4.9	5.0	5.6	6.6

Sources: Ministry of Finance; and Fund staff estimates.

[22] The higher tax revenues are based on expected improvements in administration, forthcoming changes in the coverage and rate structure of the simplified tax (Attachment II, Table 2), and the effect of the recently introduced the minimum tax on turnover. These measures should yield additional revenues from the simplified tax, the VAT, and the profit tax.

[23] Armenia has qualified for grant disbursements from the Millennium Challenge Account and could receive grants totaling 2–3 percent of GDP during the next three years.

26. **The projected fiscal stance is compatible with macroeconomic stability.** The fiscal deficit in 2005 is projected at 2.3 percent of GDP, which is a somewhat looser stance compared to the estimated outturn for 2004 and is explained by the higher social and infrastructure spending. The projected amount of domestic financing (0.5 percent of GDP) is consistent with a monetary program based on 14.5 percent money growth and a further accumulation of international reserves.



Monetary policy

27. **The stance of monetary policy is appropriate and will be supported by increased use of domestic instruments.** Growing confidence in the banking system should contribute to further increases in money demand and greater financial intermediation. At the same time, the central bank intends to maintain a prudent monetary policy to achieve its annual inflation objective of 3 percent. In addition, and to ensure that the recent increase in credit growth remains sustainable, the staff encouraged the authorities to carefully monitor lending practices and the quality of loan portfolios. Given the still limited array of indirect instruments of monetary policy, the staff welcomed the central bank's efforts to augment its stock of government securities as this will allow for their use in open market operations.[24]

C. Structural Reforms

28. The authorities agreed on the need to invigorate the reform momentum by proceeding with the implementation of pending reforms under the PRGF-supported program and formulating a plan of action for the next few months. The discussions focused on reforms in the areas of tax and customs administration, expenditure management, the banking system, the energy and water sectors, and governance.

Fiscal reforms

29. **The authorities expressed broad agreement with the staff recommendations to tackle weaknesses in tax administration (Box 3).** They agreed on the need to enhance the operations of the large taxpayers unit and ensure the wide use of risk-based approaches to auditing, VAT refunds, and arrears collection. In this regard, the authorities prepared in October a draft two-year program of priority reforms to improve efficiency and revamp the organizational structure of the tax service in line with recent advice from the Fund's Fiscal Affairs Department. The program contemplates legislative changes to facilitate effective tax audits, prevent further accumulation of VAT refunds arrears,[25] and write-offs from the books

[24] The mission also suggested to revisit the central bank's standing facilities. The deposit facility does not extend beyond 14 days and interest rates paid on it are too low to attract funds from the banking system.

[25] The bookkeeping of VAT refunds is cumbersome and has led to claims that amounted to 1.3 percent of GDP at end-December 2003. However, a large part of this amount is related to mistakes, companies that are no

illegitimate refund claims and unrecoverable tax arrears.[26] While the intended reforms are appropriate, some implementation dates are not ambitious enough. Lastly, to ensure the success of these reforms, the staff advised the authorities to unify the tax and customs agencies under the umbrella of the Ministry of Finance. However, there is no consensus within the government about this particular step.

30. **Similar to tax administration, the authorities need to combat discretion and improve transparency at customs.** They should press ahead with the implementation of the remaining reforms, namely increasing further the use of declared transaction values in assessing customs duties and VAT, following risk-based methods for inspection and post-clearance verification of imports, and allowing for the submission of import declarations to be based on self-assessment. As they finalize the above-mentioned program of tax reforms, the authorities could usefully include in the program priority reforms in the area of customs administration.

31. **The staff encouraged the authorities to ensure the efficient and transparent allocation of higher social and infrastructure spending.** This requires the close monitoring of recent decentralization measures and capacity building. A large portion of Armenia's social spending is now channeled through government-owned "noncommercial organizations."[27] With World Bank support, the authorities are expected to take additional steps to fully restore financial reporting and accountability for these organizations.[28, 29] In the context of forthcoming assistance under the U.S. Millennium Challenge Account, the authorities are developing a plan for additional investments in transportation, water and irrigation, and agriculture.

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longer in operation, and invalid claims. The authorities intend to clear their books within the next few months and repay the outstanding stock of claims to exporters by mid-2006. They are also committed to prevent the further accumulations of arrears.

[26] In mid-2004, the stock of tax arrears from companies was equivalent to 5 percent of GDP. However, only about 0.5 percent of GDP is believed to be recoverable, and the authorities expect to collect this amount during the next two years. The bulk of the stock is deemed unrecoverable as it corresponds to nonexistent or nearly bankrupt companies and will therefore be written off.

[27] In early 2003, about 5000 budgetary organizations (nearly 15 percent of the budget) were given a different legal status as part of a wide decentralization reform. However, these entities (mainly schools and hospitals) were not subject to sufficient auditing and reporting procedures, rendering their activities less transparent.

[28] Some measures to restore financial reporting and accountability in government-owned organizations that were formerly part of the central government budget have been introduced under the PRGF-supported program, but remain to be fully implemented. It is also necessary to establish reporting mechanisms for similar organizations owned by local governments.

[29] Fund and World Bank staff coordinate their activities in these and other areas. Fund staff takes the lead on macroeconomic policy issues, budget formulation and execution, quasi-fiscal deficits, tax reforms, debt management, and statistics. Areas of shared responsibility include financial sector, customs, and energy sector reforms. The Bank takes the lead on PRSP-related issues including social spending allocations, poverty and labor market analysis, public expenditure reforms, health and education reforms, decentralization, procurement and financial accountability assessments, anti-corruption, trade and transportation, judicial reform, business environment, rural infrastructure, civil service reform, and water and irrigation sector reforms.

Box 3. Armenia's Tax System: Status and Staff Recommendations

Weaknesses in tax administration remain the main constraint to revenue collection. A large gap between actual and potential collection is evidence of Armenia's tax revenue potential. Tax administration reforms during the last two years focused on setting up the operations of the large taxpayers unit, putting in place codes of conduct and internal audit units in the tax and customs agencies, disseminating tax laws and regulations, and enhancing the authority of the tax service to collect arrears. This, however, has not been accompanied by organizational improvements and the effective implementation of laws and regulations. The large taxpayers unit collects just 23 percent of total revenues, while it could potentially collect up to 75 percent. Discretionary behavior and organizational deficiencies within the tax service, and creative accounting practices by companies all contribute to this disappointing performance. Looking ahead, the staff has recommended specific steps to revamp the internal organization of the tax service and implement risk-based systems for audit and administration of VAT refunds. A similar set of recommendations applies to customs operations. In addition, both tax and customs should be brought under the control of the Ministry of Finance in order to improve coordination and ensure consistency between policies and administration.

While improving tax administration should be the top priority, there is also room to improve tax policy environment. Armenia's tax system is generally well designed and characterized by low and uniform rates. The main tax policy reforms in the last two years focused on reducing VAT exemptions on imports and improving legislation to limit the erosion of the tax base. In the medium-term, the authorities will need to streamline a number of overlapping taxes which lead to a fragmentation of the tax base. First, there is a simplified tax intended for small taxpayers which has lower rates than the regular tax regime (profit, income, and value-added taxes). However, it has provided incentives for the fragmentation of large businesses that take advantage of its lower rates and switch between regimes to minimize tax liabilities. Second, presumptive taxes on certain products were introduced in the mid-1990s because of administrative difficulties in covering them with the regular regime. There will soon be scope to begin covering these activities with the VAT. Third, a rather complex set of laws and regulations has emerged in recent years highlighting the importance of compiling a unified tax code. Fourth, the remaining VAT exemptions on imports of selected intermediate inputs and capital goods (equivalent to about 15 percent of total imports) should be removed, as they undermine the integrity of the tax system, distort price signals, and create an uneven playing field among importers. Lastly, the authorities need to ensure that the profit tax holiday for foreign investments is not renewed beyond its expiration in 2007.

Banking system

32. **The authorities need to proceed with additional financial sector reforms to foster financial intermediation.** The staff welcomed the central bank's plans to improve corporate governance in banks and strengthen creditors' rights by streamlining the collateral registration and recovery process. The authorities agreed on the need to improve financial reporting by firms and governance in the judicial system. Lastly, the authorities need to follow up on recent recommendations from the Monetary and Financial Systems Department to improve the financial market infrastructure and develop new financial instruments.

33. **The central bank unveiled plans to fine-tune banking supervision.** It is considering enhancements to the risk weights used to compute capital adequacy ratios and a tightening of exposure limits. The staff views these proposals as broadly appropriate and pointed to the upcoming FSAP update as an opportunity to discuss them in detail. A number of banks have been lobbying for a relaxation of criteria to fulfill the new minimum capital

requirement of US$5 million that will become effective in mid-2005. The staff urged the authorities to take a strict approach to enforce the new capital requirements.

34. **The staff highlighted the advantages of deepening the domestic debt market.** The domestic debt-to-GDP ratio remains below 3 percent and the government securities market is thin and lacks liquidity. The staff encouraged the authorities to deepen the debt market by issuing more government bonds not just to improve monetary management but also to foster the creation of a yield curve, tap domestic savings more aggressively, and provide a platform for private debt issues. The authorities agreed, but they are likely to proceed in a gradual way because the Ministry of Finance is concerned about the costs and risks of over-funding the budget at this time.

Quasi-Fiscal Sectors

35. **The energy sector is reaching the last stage of reforms.** Since 2002, privatization and other reforms led to a substantial transformation of the sector. Losses arising from technical deficiencies and theft have fallen, collection rates have increased to nearly 100 percent, and the primary balance has gone from deficit to surplus. The recent removal of Armenergo from transactions in the energy sector allows for direct contracting between the distribution company, the generation companies, and the dispatch companies, thereby reducing quasi-fiscal losses and opportunities for graft. Despite some delays, the authorities approved in October the minimal regulatory framework governing market mechanisms for electricity trading as envisaged under the program. The authorities are now expected to complete these regulations and proceed with an audit of Armenergo and its subsequent liquidation by mid-2005. Lastly, they need to ensure the orderly write off and settlement of debts as envisaged in the medium-term financial rehabilitation plan approved in November 2003.

Armenia: Selected Indicators for the Quasi-Fiscal Sectors, 2001–04 1/

	2001	2002	2003	2004 Proj.
Primary balance (in percent of GDP)	-3.6	-1.2	-0.6	-0.3
Energy	-2.5	-0.4	0.0	0.1
Water	-0.5	-0.4	-0.3	-0.2
Irrigation	-0.5	-0.4	-0.3	-0.2
Electricity transmission and distribution				
Technical and other losses (in percent of electricity distributed)	26	26	4	3
Collection rate (in percent of current billings)	81	90	101	100

Sources: Armenian authorities; and Fund staff estimates.
1/ Includes state-owned companies only.

36. **Although reforms in the water and irrigation sectors have been progressing, more needs to be done to improve efficiency and ensure these sectors' financial viability.** The primary deficits in these sectors have declined in recent years, but there are still problems with technical losses and theft. In addition, the pace of tariff increases should be stepped up as planned to reach cost-recovery by 2007. Lastly, the authorities need to develop the water infrastructure and improve efficiency and accountability in the users' associations that are now in charge of managing the irrigation networks.

Governance

37. **The staff encouraged the authorities to accelerate the implementation of the government's anti-corruption strategy.** In June 2004, a high-level council was created to implement the strategy. The council, in turn, created a monitoring committee with civil society and parliamentary representation. The staff encouraged the authorities to move ahead

with the three-year strategy which included measures to harmonize legislation on sanctions for corruption and witness protection, reduce corruption in the tax and customs agencies, build an independent judiciary, introduce financial audit standards in the public sector, and strengthen the role of parliament in the audit process. While the authorities expressed their intention to implement the strategy, it is yet unclear whether there is enough ownership within the government to do so.

Technical Assistance and Data Issues

38. The authorities expressed satisfaction with the substantial amount of technical assistance provided by the Fund during the last two years (Appendix II). While the assistance has been broadly effective, there have been some delays and inefficiencies in implementing the respective recommendations. These shortcomings can be attributed to capacity constraints and, in certain areas, insufficient ownership. Future needs involve national accounts methodology and details on the implementation of forthcoming tax administration and banking reforms. The latter will be prioritized after the FSAP update planned for early 2005.

39. The quality and timeliness of economic and social statistics have improved significantly over the past three years, although real sector, fiscal, and balance of payments data require further enhancements (Appendix V). Armenia subscribes to the Special Data Dissemination Standard, and the data provided to the Fund are generally adequate for surveillance and program monitoring.

D. Medium-Term Outlook

40. **Armenia faces four key medium-term policy challenges to sustain high growth rates and reduce poverty.** First, forthcoming budgets and the medium-term expenditure framework need to preserve macroeconomic stability, improve fiscal transparency, and focus on PRSP priorities on social and infrastructure spending, including in rural areas. Second, the authorities should revamp tax and customs administration and foster a level playing field among taxpayers. This will improve the environment for private sector activity and will generate additional revenues to finance poverty-reducing and growth-enhancing expenditures. Third, there is a need to complete legislative reforms to foster financial sector development and improve corporate governance in banks. Higher financial intermediation will channel resources to new companies and investments. Fourth, corruption should be tackled more forcefully and the judicial system should function more efficiently and transparently.

41. **Assuming a consistent reform effort, Armenia's medium-term economic outlook envisages fast growth, low inflation, and robust fiscal and external positions** (Table 11). Growth should be supported by further improvements in the business environment. The

medium-term economic framework envisages an increase in the investment-to-GDP ratio to over 23 percent and a continuation of the export-led growth process. The recently-updated debt sustainability analysis showed that Armenia's debt position is sustainable under different scenarios (IMF Country Report No. 04/136). During the next three years, external financing could increase in light of grant disbursements from the U.S. Millennium Challenge Account and other sources. These grants, combined with the expected support from the World Bank and other potential sources of financing, should be sufficient to finance the expenditure envelope envisaged in the Poverty Reduction Strategy Paper (PRSP).[30] To guide the future allocation of development funds, the staff encouraged the authorities to develop a well-prioritized public investment program. The authorities, citing capacity constraints, were noncommittal.

Armenia: Economic Indicators, 2003–08
(In percent of GDP, unless otherwise indicated)

	2003	2004	2005	2006–08 (average)
National income and prices				
Real GDP growth (percent change)	13.9	9.0	8.0	6.0
GNI per capita (in U.S. dollars)	902	1,090	1,208	1,373
Inflation (end of period)	8.6	3.0	3.0	3.0
Investment and saving				
Investment	24.7	22.0	23.2	23.3
National savings	17.9	16.4	17.6	18.6
Central government operations				
Revenue and grants	17.8	15.7	16.3	17.3
of which: tax revenue	14.0	14.4	14.9	15.7
grants	3.2	0.9	1.0	1.0
Expenditure	18.9	17.0	18.6	19.1
of which: social expenditures 1/	5.0	5.6	6.6	7.3
Overall balance (commitment basis)	-1.1	-1.3	-2.3	-1.9
External sector				
Current account balance	-6.8	-5.6	-5.6	-4.7
Debt-to-exports ratio 2/	87.0	73.4	65.2	59.4

Sources: Armenian authorities; and Fund staff estimates and projections.
1/ Defined as expenditure on health, education, and social security.
2/ In percent of exports of goods and services.

V. Staff Appraisal

42. Armenia's economy has performed remarkably well during the last three years. Prudent financial policies, structural reforms, and external financial support contributed to double-digit economic growth, low inflation, declining fiscal, quasi-fiscal, and external imbalances, and poverty reduction. Most of the targets in the PRGF-supported program were met, although some structural reforms suffered from delays or deficient implementation.

43. The authorities are well-positioned to continue with their prudent macroeconomic policies. They are expected to maintain a cautious fiscal stance and ensure that the expenditure envelope is in line with PRSP priorities on infrastructure spending. The projected fiscal deficit of about 2 percent of GDP is consistent with economic stability and debt sustainability. The staff encourages the authorities to continue rationalizing nonpriority current expenditures and proceed with the envisaged higher allocation for capital expenditures in the draft 2005 budget. Lastly, a comprehensive medium-term public investment program based on sound project selection criteria should be prepared. Such a program is needed to complement medium-term expenditure frameworks and guide future external assistance.

[30] Further financing could be provided by the EBRD and the Armenian diaspora.

44. The current stance of monetary policy aimed at lowering inflation to 3 percent by year-end is appropriate. The gradual deepening of the government debt market will facilitate monetary management and eventually provide a platform for private debt issues.

45. Armenia's flexible exchange rate has lent autonomy to monetary policy and facilitated the adjustment of the economy to external shocks. On the backdrop of a sizable improvement in competitiveness and lower debt ratios since 2001, the recent appreciation of the dram is a welcomed development as it facilitates the natural adjustment of the real exchange rate and offsets the impact of higher import prices on inflation.

46. Notwithstanding the progress made so far, certain structural reforms need to be completed to sustain growth and achieve further poverty reduction. The priorities should be strengthening tax and customs administration, improving expenditure management, deepening banking sector reforms, completing energy and water sector reforms, and adopting a vigorous approach to resist corruption and vested interests.

47. Despite improvements in recent years, the administration of tax and customs remains weak because of managerial and organizational shortcomings. In this regard, the staff welcomes the authorities' draft of a two-year plan of priority reforms in these areas and urges them to advance the calendar for implementation of such reforms as well as to include in the plan key measures to improve customs administration. In addition, tax and customs operations should be brought under the control of the Ministry of Finance. Lastly, the staff welcomes the authorities' plan to simplify the tax system and compile a unified tax code, and encourages the authorities to eliminate the remaining VAT exemptions on imports.

48. The much-needed steps to improve fiscal transparency in state-owned noncommercial organizations are just beginning to yield results. Given the importance of these organizations within the budget and PRSP priorities, the authorities should intensify the monitoring and auditing of these organizations to ensure that their capacity, accountability, and potential for results are good enough to justify increasingly generous budget allocations.

49. The banking system has strengthened during the last two years, and the authorities are developing a strategy to foster financial intermediation. After years of stagnation in credit to the private sector, the staff welcomes the recent increase and encourages the authorities to press ahead with their plans to strengthen prudential norms, improve corporate governance in banks, streamline collateral recovery procedures, and improve court processes.

50. Notwithstanding improvements in recent years, more work remains to be done on the quasi-fiscal sectors and on governance. Reforms in the energy sector need to be completed through further privatization and settlement of pending debts. As the water and irrigation sectors have lagged behind, it is now important to proceed with plans to increase water tariffs toward cost-recovery levels and strengthen the water infrastructure with the support of the World Bank. Regarding governance, the implementation of the recently prepared anti-corruption strategy needs to be stepped up and complemented with appropriate penalties for abuse and an efficient and independent judicial system.

51. Armenia's economic outlook is favorable, but it is not without risks. The most important risks are on the domestic front, where intermittent political turmoil and insufficient resolve to deal with problems in tax collection and strengthen the legal, judiciary, and banking systems could damage growth prospects and impede a meaningful reduction in poverty rates. Effective political leadership will be required to fight corruption and vested interests and counterbalance these risks. In addition, the external position remains vulnerable as a result of the unresolved conflict with Azerbaijan, the trade blockade by Turkey, and limited export diversification. Lastly, Armenia's dependence on grants and foreign financing means that any disruptions in their disbursements could have an adverse effect on fiscal and macroeconomic stability. This reinforces the importance of building a domestic revenue base and deepening financial markets.

52. The authorities agreed with the thrust of the ex post assessment of past Fund-supported programs and expressed interest in a successor PRGF arrangement. A Fund-supported program could play a useful role in completing Armenia's reform agenda in the areas of Fund competence, but political resolve at the highest levels of government will be required to ensure the proper implementation of ongoing and pending reforms.

53. Given Armenia's good overall performance under the program and the recent implementation of the structural performance criteria on the energy sector originally scheduled for end-July 2004, the staff supports the authorities' request of a waiver for the nonobservance of these conditions and recommends the completion of the sixth and final review under the PRGF arrangement.

54. Armenia's data are generally adequate for surveillance and program monitoring. It is proposed that the next Article IV consultation with Armenia be held in accordance with the provision of the Executive Board Decision No. 12854-(02/96), 9-/12/02.

Table 1. Armenia: Fund Disbursements and Timing of Reviews, 2001–04

Date of Availability	Conditions	Amount (in millions of SDRs)
May 23, 2001	Board approval of the PRGF arrangement	10.00
September 25, 2002	Completion of first and second reviews (end-June 2001 and end-December 2001 quantitative performance criteria and relevant structural performance criteria)	20.00
April 2, 2003	Completion of third review (end-December 2002 quantitative performance criteria and relevant structural performance criteria)	10.00
November 24, 2003	Completion of fourth review (end-June 2003 quantitative performance criteria and relevant structural performance criteria)	10.00
May 3, 2004	Completion of fifth review (end-December 2003 quantitative performance criteria and relevant structural performance criteria)	10.00
December 1, 2004	Completion of sixth review (end-June 2004 quantitative performance criteria and relevant structural performance criteria)	9.00

Sources: Finance Department (IMF); and Fund staff.

Table 2. Armenia: Selected Economic and Financial Indicators, 2001–05

	2001	2002	2003	2004		2005
				Prog.	Proj.	Proj.
	(Annual percentage change, unless otherwise indicated)					
National income and prices						
Real GDP growth	9.6	13.2	13.9	7.0	9.0	8.0
Gross domestic product (in billions of drams)	1,176	1,362	1,623	1,784	1,840	2,047
Gross domestic product (in millions of U.S. dollars)	2,120	2,373	2,805	3,151	3,408	3,826
Gross national income per capita (in U.S. dollars)	680	767	902	996	1,090	1,208
CPI (end of period)	2.9	2.0	8.6	3.0	3.0	3.0
GDP deflator	4.0	2.4	4.6	3.0	4.0	3.0
Investment and saving (in percent of GDP)						
Investment	19.8	21.7	24.7	20.9	22.0	23.2
National savings	10.3	15.4	17.9	15.0	16.4	17.6
Money and credit (end of period)						
Reserve money	11.1	38.4	6.6	3.9	4.2	11.4
Broad money	4.3	34.0	10.4	10.5	15.0	14.5
Commercial banks' 3-month lending rate (in percent) 1/	27.7	23.4	22.3	...	17.8	…
Government operations (in percent of GDP)						
Revenue and grants	17.0	18.8	17.8	15.7	15.7	16.3
Expenditure and net lending	20.9	19.3	18.9	17.7	17.0	18.6
Overall balance on a commitment basis	-3.8	-0.4	-1.1	-1.9	-1.3	-2.3
Overall balance on a cash basis	-4.0	-2.6	-1.5	-1.9	-1.3	-2.3
Stock of domestic expenditure arrears	3.6	1.3	0.0	0.0	0.0	0.0
Primary balance of the energy sector (in percent of GDP) 2/	-2.5	-0.4	0.0	0.1	0.1	0.1
External sector						
Exports of goods and services (in millions of U.S. dollars)	540	698	903	1,013	990	1,095
Imports of goods and services (in millions of U.S. dollars)	-978	-1,107	-1,406	-1,516	-1,511	-1,641
Exports of goods and services	20.8	29.3	29.5	12.1	9.6	10.5
Imports of goods and services	1.2	13.2	27.0	7.8	7.4	8.7
Current account (in percent of GDP)	-9.5	-6.2	-6.8	-5.9	-5.6	-5.6
External debt-to-exports ratio 3/	132	131	87	74	73	65
Debt service ratio 4/	9.7	9.5	7.2	7.3	6.8	5.3
Import cover 5/	3.6	3.7	4.0	3.7	3.7	3.4
Nominal effective exchange rate 6/	3.4	-5.8	-4.6	…	7.5	…
Real effective exchange rate 6	-2.0	-10.8	-2.7	...	10.8	…
Memorandum item:						
Population (in millions)	3.213	3.210	3.212	...	3.214	3.246

Sources: Armenian authorities; and Fund staff estimates and projections.

1/ End of period. The figure for 2004 correspond to data in September.

2/ Comprises state-owned energy companies. Data for 1999–02 include the electricity distribution company, Armelnet, which was privatized in late-2002. Data for 2003–04 exclude Armelnet and two generation companies that were also privatized.

3/ Net present value of debt in percent of the three-year moving average of exports of goods and services.

4/ In percent of exports of goods and services.

5/ Gross international reserves in months of next year's imports of goods and services.

6/ A positive sign denotes appreciation. Base year 1995=100. The calculations are based on 1999–2001 average trade weights. The figure for 2004 corresponds to the 12-month change up to August 2004.

Table 3. Armenia: Poverty Indicators and Millennium Development Goals, 1990-2015

	1990	1998/99	2000	2001/2	2015 Target
	(In percent of total population unless otherwise stated)				
1 Eradicate extreme poverty and hunger					
Population below US$2.15 (PPP) a day	..	36.8	..	...	...
Overall poverty rate	..	56.3	..	49.3	19.7
Rural poverty	...	47.7	...	44.7	...
Extreme Poverty	..	26.1	..	17.0	4.1
Prevalence of child malnutrition (in percent of children under 5)	..	3.3	2.6	...	1.4
2 Achieve universal primary education					
Net primary enrollment ratio (in percent of relevant age group)	..	..	94.0	..	100
Youth literacy rate (in percent of group ages 15-24)	99.5	99.7	99.8	99.8	100
3 Promote gender equality					
Ratio of girls to boys in primary and secondary education (in percent)	..	..	105.8	..	100
Ratio of young literate females to males (in percent of group ages 15-24)	99.7	99.8	99.9	99.9	...
Proportion of seats held by women in national parliament (in percent)	36.0	6.0	3.0	3.0	...
4 Reduce child mortality					
Under 5 mortality rate (per 1,000)	58.0	47.0	38.0	35.0	19.3
Infant mortality rate (per 1,000 live births)	50.0	42.0	35.0	31.0	16.7
Immunization, measles (in percent of children under 12 months)	93.0	96.0	92.0	93.0	...
5 Improve maternal health					
Maternal mortality ratio (modeled estimate, per 100,000 live births)	40.1	29.0	55.0	..	13.2
Births attended by skilled health staff (in percent of total)	99.7	97.4	96.8	..	...
6 Combat HIV/AIDS, malaria and other diseases					
Prevalence of HIV, female (in percent of group ages 15-24)	..	..	0.1	..	Stabilize and reduce
Incidence of tuberculosis (per 100,000 people)	..	..	69.1	77.0	Stabilize and reduce
Tuberculosis cases detected under DOTS (in percent)	..	8.0	39.0	..	Stabilize and reduce
7 Ensure environmental sustainability					
Nationally protected areas (in percent of total land area)	..	7.4	7.6	7.6	...
GDP per unit of energy use (PPP $ per kg oil equivalent)	1.4	3.3	3.5	..	...
CO2 emissions (metric tons per capita)	1.1	1.1		..	...
Access to an improved water source (% of population)	..	..	86.9	..	...
Access to improved sanitation (% of population)	..	..	62.9	..	...
8 Develop a Global Partnership for Development					
Fixed line and mobile telephones (per 1,000 people)	..	153.3	146.7	..	...
Personal computers (per 1,000 people)	..	2.4	7.9	..	...
General indicators					
Population (in millions)	3.5	...	3.3	3.2	...
Adult literacy rate (in percent of group ages 15 and over)	97.5	98.0	98.5	98.6	...
Total fertility rate (births per woman)	2.6	1.6	1.4	1.5	...
Life expectancy at birth (years)	71.7	72.3	74.2	74.8	...
Gini index of inequality (consumption)	...	29.8	...	27.2	...
Gini index of inequality (income)	...	63.5	...	44.7	...

Source: World Development Indicators database, April 2002

Goal 1: Halve, between 1990 and 2015, the proportion of people whose income is less than US$2.15 a day. Halve, between 1990 and 2015, the proportion of people who suffer from hunger.

Goal 2: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.

Goal 3: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later

Goal 4: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.

Goal 5: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.

Goal 6: Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases.

Goal 7: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water.

Goal 8: Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the Special Needs of landlocked countries and small island developing states. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth.

Table 4. Armenia: Central Government Operations, 2001–05 (continued)

	2001 1/	2002 1/	2003 1/	2004			2005
				Prog.	Prog. incl. sup. budget	Rev. Prog. 2/	Proj.
	(In billions of drams)						
Total revenue and grants	200.4	256.8	288.9	280.8	280.8	289.7	333.4
Total revenue	182.0	209.3	236.6	266.1	266.1	273.5	313.3
Tax revenue	168.5	198.6	227.4	260.0	260.0	265.0	306.0
Nontax revenue	11.9	8.9	5.9	5.3	5.3	7.2	7.0
Capital revenue	1.6	1.8	3.2	0.7	0.7	1.3	0.3
Grants 3/	18.5	47.5	52.3	14.7	14.7	16.2	20.1
Total expenditure	245.4	262.3	306.7	315.6	327.5	313.2	380.9
Current expenditure	185.2	188.8	208.3	243.8	245.6	242.5	290.0
Wages	25.7	28.5	35.2	41.7	41.7	41.7	45.1
Subsidies	6.5	8.1	14.7	14.1	15.6	15.6	11.6
Interest	14.5	11.0	11.2	13.1	13.1	10.9	11.1
Transfers	46.8	49.3	47.6	54.1	54.1	53.0	67.7
Goods and services 3/	91.6	91.8	99.6	121.0	121.2	121.3	154.5
Capital expenditure and net lending	60.3	73.5	98.4	71.7	81.9	70.7	90.9
Capital expenditure	43.7	64.2	92.0	60.4	70.6	59.4	80.7
Foreign financed 4/	32.0	55.3	68.5	40.0	50.2	40.5	48.9
Domestically financed 5/	11.7	8.9	23.4	20.4	20.4	18.9	31.8
Net lending	16.6	9.3	6.5	11.3	11.3	11.3	10.2
Overall balance (commitment)(-)	-45.0	-5.5	-17.9	-34.8	-46.7	-23.5	-47.4
Net clearance of arrears (plus = accumulation) 6/	-1.5	-29.1	-6.7	0.0	0.0	0.0	0.0
Statistical discrepancy/financing gap	0.0	-0.9	0.0	0.0	0.0	0.5	0.0
Overall balance (cash)	-46.5	-35.5	-24.6	-34.8	-46.7	-23.0	-47.4
Deficit/financing	46.5	35.5	24.6	34.8	46.7	23.0	47.4
Domestic financing	14.4	-6.3	-2.8	3.1	4.3	-8.4	9.5
Banking system	0.1	-8.4	-15.6	1.8	3.0	-10.1	9.5
Central Bank of Armenia	0.0	-18.0	-21.8	-1.3	-1.3	-9.7	3.6
Commercial Banks	0.1	9.5	6.2	3.1	3.1	-0.4	5.9
Nonbank	14.3	2.1	12.8	1.3	1.3	1.7	-0.1
External financing	32.1	41.8	27.4	31.6	42.4	31.4	38.0
Gross inflow	44.3	51.4	53.0	44.6	55.4	45.2	46.5
Amortization due	-11.6	-13.3	-17.3	-13.0	-13.0	-13.9	-8.5
Change in arrears (- reduction)	-0.6	3.7	-10.2	0.0	0.0	0.0	0.0
Debt deferral	0.0	0.0	1.9	0.0	0.0	0.0	0.0

Table 4. Armenia: Central Government Operations, 2001–05 (concluded)

	2001 1/	2002 1/	2003 1/	2004			2005
				Prog.	Prog. incl. sup. budget	Rev. Prog. 2/	Proj.
	(In percent of GDP, unless otherwise noted)						
Total revenue and grants	17.0	18.8	17.8	15.7	15.7	15.7	16.3
Total revenue	15.5	15.4	14.6	14.9	14.9	14.9	15.3
Tax revenue	14.3	14.6	14.0	14.6	14.6	14.4	14.9
Nontax revenue	1.0	0.7	0.4	0.3	0.3	0.4	0.3
Capital revenue	0.1	0.1	0.2	0.0	0.0	0.1	0.0
Grants 3/	1.6	3.5	3.2	0.8	0.8	0.9	1.0
Total expenditure	20.9	19.3	18.9	17.7	18.4	17.0	18.6
Current expenditure	15.7	13.9	12.8	13.7	13.8	13.2	14.2
Wages	2.2	2.1	2.2	2.3	2.3	2.3	2.2
Subsidies	0.6	0.6	0.9	0.8	0.9	0.8	0.6
Interest	1.2	0.8	0.7	0.7	0.7	0.6	0.5
Transfers	4.0	3.6	2.9	3.0	3.0	2.9	3.3
Goods and services 3/	7.8	6.7	6.1	6.8	6.8	6.6	7.5
Capital expenditure and net lending	5.1	5.4	6.1	4.0	4.6	3.8	4.4
Capital expenditure	3.7	4.7	5.7	3.4	4.0	3.2	3.9
Foreign financed 4/	2.7	4.1	4.2	2.2	2.8	2.2	2.4
Domestically financed 5/	1.0	0.7	1.4	1.1	1.1	1.0	1.6
Net lending	1.4	0.7	0.4	0.6	0.6	0.6	0.5
Overall balance (commitment)(-)	-3.8	-0.4	-1.1	-1.9	-2.6	-1.3	-2.3
Net clearance of arrears (plus = accumulation) 6/	-0.1	-2.1	-0.4	0.0	0.0	0.0	0.0
Statistical discrepancy/financing gap	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Overall balance (cash)	-4.0	-2.6	-1.5	-1.9	-2.6	-1.3	-2.3
Deficit/financing	4.0	2.6	1.5	1.9	2.6	1.3	2.3
Domestic financing	1.2	-0.5	-0.2	0.2	0.2	-0.5	0.5
Banking system	0.0	-0.6	-1.0	0.1	0.2	-0.6	0.5
Central Bank of Armenia	0.0	-1.3	-1.3	-0.1	-0.1	-0.5	0.2
Commercial Banks	0.0	0.7	0.4	0.2	0.2	0.0	0.3
Nonbank	1.2	0.2	0.8	0.1	0.1	0.1	0.0
External financing	2.7	3.1	1.7	1.8	2.4	1.7	1.9
Gross inflow	3.8	3.8	3.3	2.5	3.1	2.5	2.3
Amortization due	-1.0	-1.0	-1.1	-0.7	-0.7	-0.8	-0.4
Change in arrears (- reduction)	-0.1	0.3	-0.6	0.0	0.0	0.0	0.0
Debt deferral	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Memorandum items							
Tax revenue/estimated tax base (in percent) 7/	15.7	16.4	16.3	16.9	16.9	16.7	17.1
Overall balance excluding grants (commitment)(-)	-5.4	-3.9	-4.3	-2.8	-3.4	-2.2	-3.3
Change in domestic expenditure arrears (in billions of drams)	-1.2	-25.5	-6.7	0.0	0.0	0.0	0.0
Government and government-guaranteed debt	45.3	46.6	40.9	37.8	37.8	34.6	32.9
of which: domestic debt 8/	2.1	2.6	2.6	2.6	2.6	2.4	2.5
Nominal GDP (in billions of drams)	1,176	1,362	1,623	1,784	1,784	1,840	2,047

Sources: Ministry of Finance and Economy, Central Bank of Armenia, and Fund staff estimates.

1/ For better comparability, the composition of expenditures for 2001–03 have been adjusted to reflect changes in expenditure categories brought about by the reclassification of budgetary institutions as non-commercial enterprises in 2003 and the reclassification of public order and safety wages previously classified in goods and services.
2/ Includes expenditure authorized by the supplementary budget, but not included in the original program.
3/ The projected increase in 2005 is mostly due to the envisaged increases in education and health.
4/ The figure for 2005 includes US$20 million in estimated grant disbursements from the Millenium Challenge Account. The actual figure will be reflected in the budget after it is confirmed.
5/ The figure for 2003 includes a recapitalization of state-owned water companies amounting to 0.3 percent of GDP.
6/ Excluding external arrears on principal which are included in external financing.
7/ The tax base is estimated as GDP minus 90 percent of the value-added in construction, which is largely tax-exempt due to international agreements with official and private donors.
8/ Excluding domestic expenditure arrears.

Table 5. Armenia: Monetary Accounts, 2003–05
(In billions of drams, unless otherwise indicated)

	2003	2004						2005
	Dec.	March	June		Sept.	Dec.		Dec.
	Act.	Act.	Prog.	Act.	Est.	Prog.	Rev. Prog.	Proj.
Central Bank of Armenia								
Net foreign assets	158.5	149.1	143.0	137.8	142.5	152.0	170.5	266.7
Net international reserves	162.0	152.8	150.2	143.7	141.9	159.2	160.4	176.4
Special privatization account	4.6	4.7	4.6	5.0	11.1	4.6	21.0	101.2
Medium and long-term	-8.6	-8.4	-11.8	-10.9	-10.5	-11.8	-10.9	-10.9
Net domestic assets 1/	-39.9	-45.7	-35.9	-31.5	-28.3	-28.8	-47.0	-129.1
Claims on government (net)	-31.5	-35.2	-30.6	-32.3	-33.2	-32.8	-41.2	-37.7
Claims on banks	8.7	4.3	8.5	9.1	11.7	13.5	11.0	12.6
Other items (net) 1/	-17.1	-14.8	-13.8	-8.3	-6.8	-9.5	-16.8	-104.0
Reserve money	118.6	103.4	107.1	106.3	114.1	123.2	123.5	137.6
Currency issue	96.8	84.3	89.6	87.0	92.1	104.8	102.9	115.8
Deposits	21.7	19.1	17.5	19.2	22.0	18.4	20.7	21.7
Banking system								
Net foreign assets	203.0	196.2	185.4	181.9	190.2	200.2	215.9	314.8
Net domestic assets 1/	30.8	30.4	38.6	50.8	63.3	58.2	53.0	-6.9
Claims on government (net)	-14.6	-17.9	-11.0	-14.3	-14.1	-12.8	-24.7	-15.2
Credit to non-government sector	103.2	109.9	106.0	121.1	131.9	113.5	136.3	175.1
Other items (net) 1/	-57.7	-61.6	-56.4	-56.0	-54.4	-42.5	-58.6	-166.8
Broad money	233.8	226.6	224.1	232.7	253.5	258.4	268.9	307.9
Currency in circulation	92.0	79.5	85.1	82.3	86.3	98.2	99.5	112.1
Deposits	141.8	147.1	138.9	150.4	167.2	160.2	169.4	195.8
Domestic currency	41.4	40.3	44.8	41.1	39.8	51.7	50.0	61.9
Foreign currency	100.4	106.8	94.1	109.3	127.4	108.5	119.4	133.9
Memorandum items								
Exchange rate (in drams per U.S. dollar, end of period)	566.0	561.9	566.0	534.5	508.2	...	...	...
Privatization account (in millions of US$)	8.2	8.4	8.1	9.3	21.8	8.1	39.3	189.3
NIR (in millions of U.S. dollars) 2/	286.3	271.9	...	268.9	279.2	...	...	...
NIR (in millions of U.S. dollars) 3/	282.5	272.3	265.3	267.6	277.1	281.3	300.0	330.0
NDA of the CBA (in billions of drams) 3/	-39.2	-42.1	-31.3	-33.4	-30.9	-24.2	-26.0	-28.0
12-month change in reserve money (in percent)	6.6	10.8	12.3	11.4	10.4	3.9	4.2	11.4
12-month change in broad money (in percent)	10.4	23.6	15.0	19.4	19.6	10.5	15.0	14.5
12-month change in private sector credit (in percent)	5.0	25.2	14.5	30.8	42.6	10.0	32.1	28.5
Velocity of broad money (end of period)	6.9	…	...	...	...	6.9	6.8	6.6
Money multiplier	1.97	2.19	2.09	2.19	2.22	2.10	2.18	2.24
Dollarization in bank deposits 4/	70.8	72.6	67.7	72.7	76.2	67.7	70.5	68.4
Dollarization in broad money 5/	42.9	47.1	42.0	47.0	50.3	42.0	44.4	43.5
Currency in circulation in percent of deposits	64.9	54.1	61.3	54.7	51.7	61.3	58.7	57.2
Change in net claims on government (cumulative)	-15.6	-3.3	3.6	0.4	0.5	1.8	-10.1	9.5

Sources: Central Bank of Armenia; and Fund staff estimates.

1/ The projected decline in 2005 is related to additional privatization proceeds primarily from the sale of a copper company. These proceeds will be saved in the special privatization account which is a separate account at the CBA and is subject to regular audit by Parliament. Those proceeds are not reflected in the fiscal accounts until funds are earmarked for spending within the budget.

2/ At actual exchange rates, excluding the SPA.

3/ At program exchange rates. March and June figures are based on end-December 2003 exchange rates (IMF Country Report No. 04/136, Attachment III, Table 1). September and December figures are based on end-June exchange rates.

4/ Ratio of foreign currency deposits to total deposits (in percent).

5/ Ratio of foreign currency deposits to broad money (in percent).

Table 6. Armenia: Balance of Payments, 2001–07
(in millions of USD, unless otherwise indicated)

	2001	2002	2003	2004		2005	2006	2007
				Prog.	Rev. Prog	Proj.	Proj.	Proj.
Current account	-200	-148	-191	-184	-188	-208	-208	-208
Trade balance	-420	-369	-434	-434	-451	-475	-483	-490
Exports, fob	353	514	696	771	775	860	950	1043
Imports, fob	-773	-883	-1130	-1,205	-1226	-1334	-1433	-1533
Services (net)	-18	-41	-68	-66	-69	-72	-72	-74
Credits	187	184	207	219	215	235	247	256
Debits	-204	-225	-276	-286	-285	-307	-319	-330
Income (net)	64	88	93	110	97	96	96	96
Transfers (net)	174	173	218	205	236	242	252	260
Private	102	119	158	155	183	192	202	210
Official	72	55	60	50	53	50	50	50
Capital and financial account	202	235	252	179	202	199	236	235
Capital transfers (net)	30	68	90	0	12	30	50	50
Foreign direct investment (net)	70	111	121	98	160	216	115	118
Privatization/debt swap	0	7	63	30	46	115	0	0
Retained earnings/new investment	70	104	58	68	114	101	115	118
Portfolio investment (net)	-6	2	0	0	0	0	0	0
Public sector (net)	63	70	12	56	29	51	48	44
Disbursements	80	89	92	83	83	67	63	60
of which: World Bank program support	16	36	43	20	20	...	...	...
Amortization	-17	-20	-80	-22	-54	-16	-15	-16
Other capital (net)	45	-15	29	25	1	-98	23	23
Special privatization account	13	-7	2	-16	-16	-115	0	0
Commercial banks	-29	-31	-42	15	-6	-5	-5	-10
Other private sector	61	24	69	26	23	22	28	33
Errors and omissions	12	-18	-2	0	0	0	0	0
Overall balance	13	70	59	-6	14	-9	29	27
Financing	-13	-70	-59	6	-14	-30	-66	-58
Gross international reserves (increase: -)	-20	-82	-46	12	-5	5	-34	-35
Use of Fund credit, net	3	7	2	-6	-8	-35	-31	-23
Purchases	13	25	30	28	28	...	...	...
Repurchases/repayments	-9	-18	-28	-35	-37	-35	-31	-23
Exceptional financing	4	5	-15	0	0	0	0	0
Arrears to Russia (+increase)	3	5	-17	0	0	0	0	0
Debt relief from Turkmenistan	1	0	-1	0	0	0	0	0
Debt deferral 1/	0	0	3	0	0	0	0	0
Financing gap	...	...	...	...	...	39	37	31
IMF	...	...	...	...	...	...	...	...
World Bank	...	...	...	...	...	20	20	15
Memorandum items:								
Current account (in percent of GDP)	-9.5	-6.2	-6.8	-5.9	-5.6	-5.6	-5.1	-4.7
Gross international reserves (end of period)	329	430	502	492	507	503	537	572
In months of imports	3.6	3.7	4.0	3.7	3.7	3.4	3.5	3.5
Merchandise export growth, percent change	13.9	45.5	35.5	10.8	11.3	11.0	10.5	9.8
Merchandise import growth, percent change	0.0	14.1	28.1	7.0	8.5	8.9	7.4	7.0
Nominal external debt 2/	906	1026	1098	1109	1109	1165	1212	1281
NPV of external debt in percent of exports 3/	132	131	87	74	73	65	61	59
External debt service in percent of exports	9.7	9.5	7.2	7.3	6.8	5.3	4.9	3.9
Stock of external arrears	17	17	0	0	0	0	0	0

Sources: Data provided by the Armenian authorities; and staff estimates.

1/ The figure for 2003 reflects a Lincy foundation loan onlent to small- and medium-sized enterprises. The government repaid US$15 million of the US$18 million loan and expects to pay the remainder in 2004. The Lincy Foundation has agreed to wait for the repayment.

2/ Government and government-guaranteed medium- and long-term debt.

3/Three-year moving average of exports of goods and services centered on the previous year.

Table 7. Armenia: Financial Soundness Indicators for the Commercial Banks, December 2001–June 2004 1/

(In percent unless otherwise indicated)

	2001 Dec.	2002 Dec.	2003 June	2003 Dec. 2/	2004 June
Capital adequacy					
Total regulatory capital to risk-weighted assets	13.6	30.5	34.3	33.8	34.3
Tier I regulatory capital to risk-weighted assets	12.3	28.8	32.6	32.2	32.3
Capital to total assets	8.8	18.4	18.3	18.1	17.9
Sectoral distribution of gross domestic nongovernment loans 3/					
Agriculture	12.1	9.8	10.9	8.6	8.0
Industry (excluding energy sector)	29.8	22.3	20.0	20.1	18.3
Energy sector	10.5	16.8	12.7	11.4	10.3
Construction	3.0	3.5	4.4	5.1	4.5
Transport and communications	2.4	1.2	0.8	0.7	0.9
Trade and commerce	16.5	19.0	20.7	22.7	22.1
Other	25.7	27.4	30.5	31.4	35.9
Asset quality					
Performing loans to total gross domestic nongovernment loans 3/	54.8	75.9	71.3	80.1	84.1
Standard	54.8	73.9	66.8	76.5	82.5
Watch (up to 90 days past due) 4/	...	2.0	4.5	3.6	1.6
Nonperforming loans to total gross domestic nongovernment loans 3/	23.9	12.3	14.6	9.8	7.9
Substandard (91–180 days past due)	3.3	1.5	1.8	0.6	1.0
Doubtful (181–270 days past due)	1.4	0.8	0.8	0.7	0.2
Loss (>270 days past due)	19.2	10.1	12.1	8.5	6.7
Provisions to nonperforming loans 5/	89.3	95.8	96.1	103.7	102.0
Spread between highest and lowest local currency interbank rates	29.0	7.8	2.4	2.6	2.5
Spread between highest and lowest foreign currency interbank rates	22.0	3.6	4.5	3.7	2.7
Earnings and profitability					
Return on assets 6/	-9.1	3.9	1.4	2.7	2.9
Return on earnings 6/	-78.6	21.6	7.5	14.4	16.2
Gross interest income to total gross income	77.8	63.1	65.7	62.7	67.8
Net interest margin to total gross income	27.8	37.6	42.7	42.0	46.8
Gross noninterest expense to total gross income	42.7	48.3	47.9	48.5	47.0
Liquidity					
Liquid assets to total assets 7/	33.1	44.5	49.2	47.5	44.6
Liquid assets to total short-term liabilities 7/ 8/	80.4	108.8	114.0	101.3	96.1
Customer deposits to total domestic loans 3/ 9/	198.4	195.3	188.0	177.1	160.3
Sensitivity to market risk					
Foreign currency loans to total gross domestic nongovernment loans 10/	84.7	82.5	73.7	72.7	72.1
Foreign currency liabilities to total liabilities	79.7	72.2	71.3	73.2	72.6
Gross open foreign currency position to capital	88.3	15.3	15.9	13.8	12.5

Sources: CBA; and Fund staff estimates.

1/ Excludes banks under CBA provisional administration.

2/ Includes one bank that was brought under CBA provisional administration on December 24.

3/ Loans exclude correspondent accounts and other interbank deposits. Definition of nonperforming loans amended from that in IMF Country Report No. 04/136, Attachment III, Table 4 to exclude watch loans but include loss loans; nonperforming loans now include all loans overdue by more than 90 days.

4/ Classification category introduced on January 1, 2002.

5/ Assumes 100 percent coverage of loss loans.

6/ Average assets are calculated as a simple average of quarterly data. Profit is the undistributed post-tax profit from the income statement. In the calculation of return on earnings and return on assets, the annualized profit figure (quarterly profit multiplied by 4) is taken.

7/ Liquid assets include cash, correspondent accounts and other interbank deposits, and Republic of Armenia treasury bills.

8/ Short-term liabilities include demand liabilities and overdue liabilities.

9/ Customer deposits include bank accounts, demand deposits, and term deposits of individuals, legal entities, and nonbank financial institutions.

10/ Loans include correspondent accounts and other interbank deposits.

Table 8. Armenia: Quantitative Targets, December 2003–June 2004 1/
(End of period ceilings on stocks, unless otherwise specified)

	2003	2004			
	Dec.	Mar.		June	
	Act.	Prog. 2/	Act.	Prog. 3/	Act.
		(in billions of drams)			
Net domestic assets of the CBA 4/	-35.2	-37.0	-42.1	-31.3	-33.4
Net banking system credit to the government	-14.6	-12.1	-17.9	-11.0	-14.3
Domestic arrears of the central government and the State Fund for Social Insurance	0.0	0.0	0.0	0.0	0.0
Tax revenues of the central government (floor) 5/	227.4	52.2	53.7	115.2	117.6
Adjusted target 6/					117.0
Balance of the central government on a cash basis (floor) 5/	-24.8	-6.3	-2.1	-17.4	-6.6
Adjusted target 7/				-15.0	
Reserve money (band) 2/	118.6	(103-107)	103.4	(105-109)	106.3
Primary balance of the energy sector (floor) 2/ 5/ 8/	0.7	2.5	2.3	3.0	2.9
		(in millions of dollars)			
Contracting or guaranteeing of new nonconcessional external debt with maturity of more than one year 5/	0	0	0	0	0
Net disbursements of short-term external debt 5/ 9/	0	0	0	0	0
External arrears (continuous criterion)	0	0	0	0	0
Net official international reserves (floor) 4/	286.3	267.3	267.3	265.3	267.6

1/ The definitions of the line items and the adjusters on the fiscal balance, NIR, NDA, net credit to the government and the stock of domestic arrears are specified in the Technical Memorandum of Understanding (TMU, IMF Country Report 04/136, Attachment III).
2/ Indicative target.
3/ Performance criterion, unless otherwise noted.
4/ At program exchange rates as specified in the TMU (IMF Country Report 04/136, Attachment III).
5/ Cumulative flow from the beginning of the year until the end of the month indicated.
6/ Reccorded tax revenues in June have been reduced on account of AMD 0.63 billion VAT refunds in arrears.
7/ The June target has been increased on account of AMD 2.4 billion lower than anticipated project disbursements.
8/ Excluding the balance of the distribution company and of two generation companies recently privatized.
9/ Obligations with maturity of less than one year, excluding normal import-related credit and sales of treasury bills to nonresidents.

Table 9. Armenia: Structural Measures Under the Sixth Review, May-July 2004

	Target Date	Status
Performance Criteria		
The Customs Committee will improve customs operations by:		
(i) Developing risk-based assessment profiles for post-clearance verification of imports; issuing rules for the external audits of import declarations; and preparing a report on these audits for the Chairman of the Customs Committee.	June 30	Met
(ii) Increasing to at least 50 percent of imports the share of imports for which the approved customs value is determined on the basis of the declared transaction price.		
The Public Utilities Regulatory Commission will adopt regulations enabling direct contracting among different companies in the energy sector and specifying a risk-sharing mechanism. The government will adopt and publish a decision prohibiting Armenergo from signing any new contracts and mediating any cash or non-cash transactions in the energy sector.	July 31	Implemented October 1
Benchmarks		
Develop a deferral payment system for VAT for large imported capital goods not currently taxed at the point of entry.	June 30	Implemented September 2004
Prepare a report to identify types of tax arrears, evaluate the potential for recovery and appropriate actions to that end, and determine the measures needed to write-off uncollectible debts from the STS accounts.	July 31	Met
Approve audit reform legislation to implement a system of tax audits according to established risk criteria and prepare an audit manual covering all aspects of the audit function.	July 31	Drafts received October 15
Begin regular reporting for government-owned noncommercial organizations (sequence defined in the Technical Memorandum of Understanding).	July 31	Met

Table 10. Armenia: Central Government Expenditure by Major Function, 2002–08

	2002	2003	2004 Proj.	2005 Proj.	2006-08 Proj.
			(In percent of total expenditure)		
Total Expenditure	100.0	100.0	100.0	100.0	100.0
General Public Services	9.2	9.1	10.6	9.8	9.8
Defence	14.0	14.5	15.9	13.8	13.5
Public Order and Safety	6.2	6.5	8.0	6.8	6.8
Education	11.1	11.7	14.7	15.7	16.6
Health	6.1	6.2	7.8	8.7	9.7
Social Security	9.1	9.6	11.4	12.3	12.9
Recreation, Housing, and Utilities	8.9	18.5	10.8	10.9	10.1
Agriculture, Mining, Forestry, and Water	5.8	6.2	6.4	7.2	6.8
Transportation and Communications	3.0	7.8	5.1	6.2	6.1
Other 1/	26.7	10.0	9.2	8.6	7.8
			(In percent of GDP)		
Total Expenditure	21.6	18.9	17.0	18.6	19.1
General Public Services	2.0	1.7	1.8	1.8	1.9
Defence	3.0	2.7	2.7	2.6	2.6
Public Order and Safety	1.3	1.2	1.4	1.3	1.3
Education	2.4	2.2	2.5	2.9	3.2
Health	1.3	1.2	1.3	1.6	1.8
Social Security	2.0	1.8	1.9	2.3	2.5
Recreation, Housing, and Utilities	1.9	3.5	1.8	2.0	1.9
Agriculture, Mining, Forestry, and Water	1.3	1.2	1.1	1.3	1.3
Transportation and Communications	0.6	1.5	0.9	1.2	1.2
Other 1/	5.8	1.9	1.6	1.6	1.5
Memorandum items:					
Nominal GDP (in billions of drams)	1,362	1,623	1,840	2,047	2,445
Social expenditure (in percent of total expenditure) 2/	25.2	26.5	33.0	35.5	38.1
Social expenditure (in percent of GDP) 2/	4.9	5.0	5.6	6.6	7.3

Sources: Armenian authorities and Fund staff estimates and projections.

1/ Includes amounts allocated to the reserve fund, interest on public debt, transfers to local governments, other services, and unspecified expenditures.

2/ Comprises expenditures on health, education, and social security.

Table 11. Armenia: Medium-Term Macroeconomic Framework, 2003–08

	2003	2004	2005	2006	2007	2008
	Act.	Projections				
	(In percent of GDP, unless otherwise indicated)					
National income and prices						
Real GDP growth (percent change)	13.9	9.0	8.0	6.0	6.0	6.0
Gross domestic product (in millions of U.S. dollars)	2,805	3,408	3,826	4,176	4,559	4,978
Gross national income per capita (in U.S. dollars)	902	1,090	1,208	1,287	1,371	1,461
CPI inflation, end-of-peiod (annual percent change)	8.6	3.0	3.0	3.0	3.0	3.0
Investment and saving						
Investment	24.7	22.0	23.2	23.3	23.3	23.3
Government	5.7	3.2	3.9	4.7	4.3	4.3
Other	19.0	18.8	19.3	18.6	19.0	19.0
National savings	17.9	16.4	17.6	18.2	18.6	19.0
Government	5.0	2.6	2.1	3.3	2.9	3.0
Other	12.9	13.8	15.5	14.9	15.7	16.0
Government operations						
Revenue and grants	17.8	15.7	16.3	17.2	17.2	17.5
of which: tax revenue	14.0	14.4	14.9	15.3	15.7	16.1
grants 1/	3.2	0.9	1.0	1.3	1.0	0.8
Expenditure	18.9	17.0	18.6	19.1	19.1	19.3
of which: social expenditure 2/	5.0	5.6	6.6	7.0	7.4	7.5
Overall balance (including grants)	-1.1	-1.3	-2.3	-1.9	-1.9	-1.8
Government and government-guaranteed debt	40.9	34.6	33.0	31.3	30.5	27.3
External sector						
Exports of goods and services	32.2	29.6	29.4	29.5	29.3	28.9
Imports of goods and services	50.1	45.1	44.1	43.1	42.0	40.7
Current account	-6.8	-5.6	-5.6	-5.1	-4.7	-4.3
Current account (in millions of U.S. dollars)	-191	-188	-208	-208	-208	-210
Capital and financial account (in millions of U.S. dollars)	252	202	199	236	235	229
of which: direct foreign investment	121	160	216	115	118	122
public sector disbursements	92	83	67	63	60	58
Change in gross international reserves (in millions of U.S. dollars) 3/	-46	-5	5	-34	-35	-34
Arrears and debt relief (in millions of U.S. dollars)	-15	0	0	0	0	0
Financing/gap (in millions of U.S. dollars)	0	0	39	37	31	41
of which: IMF	...	0	...	...	...	...
World Bank	...	0	20	20	15	...
External debt (NPV, in percent of exports of goods and services)	87	73	65	61	59	58
Debt service (in percent of exports of goods and services)	7.2	6.8	5.3	4.9	3.9	3.5
Gross international reserves in months of imports	4.0	3.7	3.4	3.5	3.5	3.5

Sources: Armenian authorities; and Fund staff estimates and projections.

1/ For 2005-07, the figures include preliminary projections for disbursements under the U.S. Millennium Challenge Account (US $100 million).

2/ Defined as total expenditure on health, education, and social security.

3/ A negative figure indicates an increase.

Table 12. Armenia: Indicators of Fund Credit, 2003-08

	2003 Act.	2004	2005	2006	2007	2008
	(In units indicated)					
Existing and prospective Fund oustanding credit 1/						
In millions of SDRs	144.4	145.3	124.4	103.3	87.8	70.8
In percent of exports 2/	22.4	20.5	15.9	12.1	9.5	7.1
In percent of external debt	18.4	18.3	14.9	11.9	9.6	7.9
In percent of gross reserves	40.2	40.1	34.6	26.9	21.5	16.3
In percent of quota	157.0	158.0	135.3	112.2	95.5	76.9
Existing Fund outstanding credit 1/						
In millions of SDRs	144.44	136.3	115.4	94.3	78.8	61.8
In percent of exports 2/	22.4	19.3	14.8	11.0	8.5	6.2
In percent of external debt	18.4	17.2	13.9	10.9	8.6	6.9
In percent of gross reserves	40.2	37.6	32.1	24.6	19.3	14.3
In percent of quota	157.0	148.2	125.5	102.5	85.7	67.1
Prospective Fund outstanding credit 1/						
In millions of SDRs	…	9.0	9.0	9.0	9.0	9.0
In percent of exports 2/	…	1.3	1.1	1.1	1.0	0.9
In percent of external debt	…	1.1	1.1	1.0	1.0	1.0
In percent of gross reserves	…	2.5	2.5	2.3	2.2	2.1
In percent of quota	…	9.8	9.8	9.8	9.8	9.8
Repurchases, repayments, and charges due from existing and prospective drawings						
In millions of SDRs	…	25.6	24.0	21.8	15.9	17.4
In percent of exports 2/	…	3.6	3.1	2.5	1.7	1.7
In percent of external debt	…	3.2	2.9	2.5	1.7	2.0
In percent of gross reserves	…	7.0	6.7	5.7	3.9	4.0
In percent of quota	…	27.8	26.1	23.6	17.3	19.0
Repurchases and charges due from existing drawings						
In millions of SDRs	…	25.5	23.9	21.7	15.8	17.4
In percent of exports 2/	…	3.6	3.1	2.5	1.7	1.7
In percent of external debt	…	3.2	2.9	2.5	1.7	1.9
In percent of gross reserves	…	7.0	6.7	5.7	3.9	4.0
In percent of quota	…	27.8	26.0	23.6	17.2	18.9
Repurchases and charges due from prospective drawings						
In millions of SDRs	…	0.0	0.1	0.1	0.1	0.1
In percent of exports 2/	…	0.0	0.0	0.0	0.0	0.0
In percent of external debt	…	0.0	0.0	0.0	0.0	0.0
In percent of gross reserves	…	0.0	0.0	0.0	0.0	0.0
In percent of quota	…	0.0	0.1	0.1	0.1	0.1

Sources: Armenian authorities and Fund staff estimates.

1/ End of period stocks.
2/ Exports of goods and services.

October 27, 2004

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Rato:

In May 2001, the Executive Board approved a three-year arrangement for Armenia under the Poverty Reduction and Growth Facility (PRGF). At the time of the fifth review on May 3, 2004, the arrangement was extended through December 2004 to allow additional time in order to implement additional reforms in line with the objectives of the arrangement. The purpose of this letter and the attached Memorandum of Economic and Financial Policies is to inform you of the progress in implementing the program, set out the policies for the period ahead, and request the seventh disbursement under the arrangement following the completion of the sixth review.

Economic performance in 2004 has been in line with program objectives and all quantitative performance criteria for end-June 2004 were met. While the structural reforms scheduled for implementation during the last six months were largely met, some delays occurred in relation to important fiscal and energy sector measures. These include the adoption of legislation to regulate the use of cash registers and register traders at large retail markets, the preparatory work to set up a risk-based system of tax audits, and the adoption of regulations for contracting electricity and for removing the state-owned company Armenergo from the energy sector.

On the basis of completion of the delayed measures and other actions envisaged in the near term and detailed in the attached Memorandum of Economic Policies, we hereby request the completion of the last review under the arrangement. We are also requesting a waiver for the nonobservance of the above-mentioned energy measures (performance criteria for the sixth review), which were delayed because of technical complications but have been implemented on October 1, 2004.

The government would like to continue its fruitful cooperation with the IMF and would like to proceed with discussions on a new PRGF arrangement covering the 2005–08 period after the completion of the sixth review. The policies and measures to be implemented during the next five months are designed to address more forcefully lingering inefficiencies in tax and customs administration and pave the way for continued cooperation under a new three-year arrangement. The government intends to make these understandings public and authorizes the IMF to publish this letter, the attached memorandum, and the staff report including the ex post assessment of long-term program engagement with the Fund.

Sincerely yours,

/s/
Andranik Margaryan
Prime Minister
Republic of Armenia

/s/
Vartan Khachatryan
Minister of Finance and Economy

/s/
Tigran S. Sargsyan
Chairman of the Central Bank

REPUBLIC OF ARMENIA
Memorandum of Economic Policies
October 27, 2004

1. This memorandum supplements the Memorandum of Economic and Financial Policies (MEFP) of April 2003. It updates the government's policies for 2004 and outlines the government's main economic policies for the remainder of 2004 and early 2005.

A. Recent Developments

2. Economic growth continues at high pace. Real GDP in the first eight months of 2004 expanded by 9.7 percent. The 12-month rate of inflation reached 6.1 percent in September. Broad money grew by 18.7 percent in the twelve months through August. In the first half of 2004, the outturn of the fiscal deficit on a cash basis was 1 percent of GDP compared to 3.0 percent of GDP under the program, mainly because of under-execution of expenditures. In June, parliament passed a supplementary budget amounting to an increase of expenditure by 0.6 percent of GDP. The additional expenditures are expected to be executed during a 12-month period.

3. We met all but one of the program's quantitative targets for end-June. The indicative target on the primary surplus of the energy sector was missed by a small margin because of somewhat lower-than-expected collection rates from export sales (Table 1). We established revised targets for up to end-December 2004. While the structural reforms scheduled for implementation during the last six months were largely met, some delays occurred in relation to important fiscal and energy sector measures. These include the adoption of legislation to regulate the use of cash registers and register traders at large retail markets, the initiation of a deferral system for imports of capital goods, the preparatory work to set up a risk-based system of tax audits, and the adoption of regulations for contracting electricity and for removing the company Armenergo from the energy sector. The latter was delayed because of technical complications in devising market rules and reaching understandings with other energy market participants. Despite those delays, we have taken actions to ensure that the measures envisaged in the context of the sixth review of the PRGF-supported program will be implemented by mid-November 2004.

B. Economic Policies in the Period Ahead

4. For the rest of 2004 and 2005, our macroeconomic policies will focus on price stability, a forceful implementation of tax and customs administration reforms, and fiscal transparency. Some of these policies were listed in the April 2003 memorandum of economic and financial policies but will be supplemented by additional policies as noted below and summarized in Tables 1–2.

5. **Fiscal policy.** The 2005 budget to be submitted to parliament will be based on the following key parameters. Domestic tax and nontax revenues will be targeted at

AMD 313 billion of which tax revenues will be at a minimum of AMD 306 billion, representing an increase of at least 0.4 percent of GDP from the previous year. The tax revenue target for 2005 will be adjusted if GDP developments in early 2005 suggest that such an update is warranted. Current expenditures will be at most AMD 290 billion. At the same time, we will limit expenditure increases in areas where capacity constraints, transparency, or the efficiency of expenditure are a concern. To ensure a balanced mix between current and capital expenditures, capital expenditures excluding net lending and those to be financed from the Millennium Challenge Account (MCA) will be at least AMD 70 billion. The figure for capital expenditures will include the carryover of unexecuted expenditures in the 2004 supplementary budget estimated at AMD 4 billion (0.2 percent of GDP). Once assurances are received regarding support from the MCA, those amounts will be included in the budget as additional capital expenditure. The overall deficit of the central government (including grants) will not exceed AMD 47.5 billion, which is a looser stance compared to the estimated outturn for 2004 but allows for priority social and infrastructure spending increases. Finally, the 2005 budget document will include detailed information and data on the budget allocations to noncommercial organizations.

6. **Tax and customs administration.** Despite some progress in recent years, tax and customs administration still suffer from severe deficiencies. The operations of the large taxpayers unit need to be revamped to improve collection from all large taxpayers and prevent discretionary treatment of taxpayers. To move forward, a major change in direction is required to improve efficiency and transparency in these agencies. As a result, we will finalize, in consultation with Fund staff, a two-year program of priority reforms in the area of tax policy and on tax and customs administration. The program will include a number of legislative and managerial changes to revamp tax administration. On the legislative front, we will enact legislation to facilitate the carrying out of effective tax audits, particularly in relation to large enterprises. In addition, we will enact legislation to prevent further accumulation of VAT refund arrears and will discuss with Fund staff amendments to the law on Bank secrecy to improve compliance with tax payments. On the managerial side, we will move the tax audit function in the STS to the large taxpayers unit and foster the implementation of risk-based management approaches in performing audits, collecting arrears, and processing VAT refunds by the tax and customs agencies.

7. Regarding the existing stock of **VAT excess payments** owed to exporters and domestic suppliers, we will ascertain the legitimate refund claims and remove from the books the requests of defunct companies, requests that did not follow legislative requirements and appropriate administrative procedures, and requests deemed fraudulent and therefore rejected. We will prepare, by end-November 2004, a complete list of legitimate claimants and amounts owed to each of them. Of the overall stock amounting to AMD 21 billion accumulated prior to December 31, 2003, we estimate that AMD 5.4 billion is legitimately owed to exporters. During 2005, we will repay at least AMD 4 billion in equal quarterly installments, with the remainder to be paid during the first half of 2006. If the legitimate claims owed to exporters exceed AMD 5.4 billion, we will discuss with Fund staff the modality for its repayment to ensure that all outstanding claims are fully repaid by June 2006.

At the same time, we will ensure that during 2004 and 2005 there will be no further accumulations of VAT refund arrears exporters.

8. Regarding the stock of **tax arrears** amounting to AMD 89 billion at end-June 2004, we will take steps to write-off the part of the stock that is non-recoverable in line with recent technical assistance advice from the Fund including enacting the enabling legislation by December 2004. We will collect the recoverable amounts owed by current participants of the tax system, including large enterprises and other active traders and state entities. In particular, we will assign a high-level taskforce to collect arrears from the largest 100 debtors. The task force will prepare a collection plan for the recoverable amounts with targets for 2005–06 by December 2004. Of the total recoverable amounts, we expect to collect at least AMD 4 billion in 2005. Lastly, we will ensure that there are no further increases in the stock of tax arrears by active state-owned companies, including those in the energy sector.

9. To improve the functioning of **customs administration**, we intend to achieve the following results in the near term. First, consistent with WTO principles, we will ensure that declared transaction values are increasingly used for assessing customs duties and VAT and will begin publishing on our website quarterly information on the use of transactions values. Second, we will strengthen the operations of the internal audit unit and the post-clearance verification audit unit and continue preparing audit reports. Third, we will enact the electronic signature law to make the direct trader input system operational and will conduct a wide campaign to inform traders and companies at large about the direct trader input system. Lastly, we will prepare in consultation with Fund and World Bank staff, terms of reference for an operational review of customs operations to be conducted by a specialized international company.

10. **Tax policy.** We have begun preparatory work to build a unified tax code containing an internally consistent set of tax laws and regulations. In the near term, the differentiated tax rate structure in the simplified tax will be replaced with one tax rate on turnover and with no deductions for expenses, and action will be taken to remove large taxpayers from the simplified tax regime and move them to the regular regime (VAT and profit tax).

11. **Monetary policy.** The Central Bank of Armenia (CBA), with full support of the government, will continue pursuing a tight monetary policy and will not stand in the way of an appreciation of the dram in order to ensure that inflation is lowered to its objective of 3 percent. The CBA will follow the current course of increasingly relying on open market operations in the dram money market for the day-to-day conduct of monetary policy. To enhance its implementation capacity, the CBA will continue, in cooperation with the Ministry of Finance and Economy (MFE) to augment its holdings of government securities for use both in direct sales and as collateral in repurchase contracts. To facilitate liquidity management and to develop the domestic debt market, the MFE will increase the aggregate face value of its dram-denominated securities stock by at least 6 billion in 2005.

12. **Banking system reforms.** The CBA will continue to improve the regulatory framework for commercial banks. The new minimum capital requirement of US$5 million will become effective July 1, 2005, with eligible capital to remain as is currently defined. Banks that fail to meet prudential requirements will be promptly liquidated or converted into nonbank credit organizations. Bank consolidation and new shareholder entry will be encouraged and leading banks with well-established international track record will be given preference in awarding new licenses. By end-2004, the CBA will amend its system of risk weights, making it consistent with Basel Committee recommendations under the standardized approach, and will tighten related-party exposure and large exposure limits. Finally, by end-March 2005, the Civil Code will be amended to further support creditor rights in relation to collateral registration and recovery, and the Civil Procedures Code will be amended to improve court processes governing these rights.

13. **Energy sector reforms.** As of October 1, 2004, Armenergo has been extricated from all cash and non-cash transactions and is prevented from making any new contracts in the energy sector. By end-November 2004, we will establish, according to the law, a liquidation commission to conduct a fair and transparent liquidation process, a process that would include the sale of assets, the collection of receivables and the payment of debt according to priority rules, and finally, the appropriate handling of remaining Armenergo staff. The commission will consist of experts and trusted appointees who have no interests and no involvement in the energy sector. By end-March 2005, an audit of the company for the year 2004 will be undertaken, and as standard practice, another audit will be conducted at the end of the liquidation. Subsequently, all of Armenergo's outstanding liabilities to the government will be written off, it's remaining debt restructured, and the company's removal from the enterprise registry will be initiated through the court system. In addition, the Public Services Regulatory Commission will pass the remaining elements of market rules including rules governing export sales and swaps to ensure the proper functioning and transparency in the energy sector.

14. The government believes that the policies and measures described in this memorandum are adequate, but it stands ready to take any additional measures that may be required to ensure the success of the intended reforms. The government will continue consulting with the Fund in advance of the adoption of any new policies and will provide the Fund with the information required to assess progress in implementing its program.

Table 1. Armenia: Quantitative Targets, June-December 2004
(End of period ceilings on stocks, unless otherwise specified)

	2004			
	Jun.	Sep.		Dec.
	Act.	Prog. 1/	Est.	Rev. Prog. 1/
	(in billions of drams)			
Net domestic assets of the CBA 2/	-33.4	-27.9	-30.9	-26.0
Net banking system credit to the government	-14.3	-11.0	-15.1	-24.7
Domestic arrears of the central government and the State Fund for Social Insurance	0.0	0.0	0.0	0.0
Tax revenues of the central government (floor) 3/	117.6	184.2	188.8	265.0
Balance of the central government on a cash basis (floor) 3/	-6.6	-27.9	-16.0	-23.0
Reserve money (band/level)	106.3	(110-114)	114.1	(121-126)
Primary balance of the energy sector (floor) 4/ 5/	2.9	0.0	-0.1	1.2
	(in millions of dollars)			
Contracting or guaranteeing of new nonconcessional external debt 3/ 6/	0	0	0	0
External arrears (continuous criterion)	0	0	0	0
Net official international reserves (floor)	268.9	268.3	277.1	300.0

1/ Indicative targets based on end-June exchange rates. The definitions of the line items and the adjusters on the fiscal balance, NIR, NDA, net credit to the government and the stock of domestic arrears are specified in IMF Country Report No. 04/136.
2/ The following targets will be adjusted by the full amount of lower than programmed World Bank budget support: NIR (downward), NDA of the CBA (upward), and net credit to the government (upward). The programmed amount is US$ 20 million in the fourth quarter.
3/ Cumulative flow from the beginning of the year until the end of the month indicated.
4/ Includes only state-owned companies.
5/ Excluding the balance of the distribution company and of two generation companies recently privatized.
6/ Includes debt with maturity of more than a year as well as obligations with maturity of one year or less, excluding normal import-related credit and sales of treasury bills to nonresidents.

Table 2: Structural Measures, October 2004–March 2005

Measures	Target Date 1/
Prepare a two-year program of priority reforms in tax policy and tax and customs administration in line with recent staff recommendations.	October 2004
The central bank will terminate its administration of Armcommunications Bank, either after its sale or prior to its liquidation.	November 15, 2004
Parliament will pass legislation to regulate the use of cash registers and register traders (as businesses) at large retail markets.	November 15, 2004
Enact amendment to the law on taxes providing the STS authority to write off uncollectible debts from its accounts and draft a decree establishing corresponding STS procedures in consultation with Fund staff.	December 2004
Enact legislation in line with recent IMF recommendations to facilitate the carrying out of effective tax audits, particularly in relation to large enterprises.	January 2005
Replace the differentiated tax rate structure in the simplified tax with one tax rate on turnover and with no deductions for expenses and take action to remove large taxpayers from the simplified tax regime and move them to the regular regime (VAT and profit tax).	January 2005
Implement risk management approaches in performing tax audits, collecting arrears, and processing VAT refunds.	March 2005

1/ End of period.

ARMENIA: OBJECTIVES AND OUTCOMES UNDER THE PRGF-SUPPORTED PROGRAM

The table below summarizes Armenia's progress against the objectives of the PRGF-supported program since its inception in 2001. Program conditionality was consistent with recommendations provided during the 2001 and 2002 Article IV consultations.

Policy Areas	**Main Objectives**	**Outcomes**
Economic growth and Poverty	Maintain real economic growth at least at 6 percent and reduce poverty	Objectives achieved. Real economic growth averaged 12 percent per year during 2001–03, income per capita rose by 48 percent and consumption per capita rose by 39 percent. The poverty rate fell from 56 percent in 1999 to 43 percent in 2003.
Macroeconomic stability	Keep annual inflation at around 3 percent and reduce fiscal and external current account deficits	Objectives achieved. The nominal exchange rate has been broadly stable and average annual inflation was 3.8 percent between mid-2001 and mid-2004. Between 2000 and 2003, the general government deficit fell from 6.4 percent of GDP to 1.1 percent and the current account deficit fell from 15 percent of GDP to 7 percent. Foreign exchange reserves remained at over 3.5 months of imports.
External sector	Increase export growth and lower external debt ratios	Objectives achieved. During 2001–03, exports of goods and services grew at an average rate of 27 percent per year and the external debt-to-exports ratio fell from 139 percent to 87 percent.
Tax and customs	Increase tax collection, strengthen tax and customs administration, and rationalize exemptions	Capacity constraints, discretionary behavior of collection agencies, exemptions, and influence of vested interests hindered progress in this area. There has been a gradual improvement in tax and customs administration during 2001–03 and tax exemptions were partially removed, but implementation has been deficient. Tax policy changes have been compromised by the influence of vested interests, and transparency of customs operation remains a concern.
Expenditure management	Improve efficiency and expenditure control, eliminate expenditure arrears, reduce unclassified budget expenditures	Objectives broadly achieved. The treasury system was strengthened and expenditure control procedures were put in place. Domestic and external arrears were cleared in 2003 and unclassified expenditures fell from 15.6 percent of total expenditures in 2000 to 0.8 percent in 2003. At present, about 15 percent of the budget is allocated to noncommercial organizations that were recently separated from the treasury. The move represented a loss of control and accountability for the use of public funds. The problem is beginning to be addressed through a new reporting system and related reforms.
Banking sector	Improve soundness and ability to deal with problem banks	Objectives broadly achieved. Prudential regulations were strengthened, a loan classification system was put in place, minimum capital requirements were raised, and eight problem banks were resolved. The resolution process for these banks could have been more expeditious to ensure a faster recovery of confidence in the system. Weak governance in banks and enforcement of creditor rights remain a concern.
Quasi-fiscal (energy and water sectors)	Reduce losses and improve efficiency and payment compliance	Objectives broadly achieved. A number of companies have been privatized, collection rates rose, efficiency improved, and quasi-fiscal losses have been substantially reduced. Further privatization of state-owned energy and gas companies is needed.
Governance	Increase transparency and reduce corruption	The business environment has improved. License procedures were simplified, internal audit functions were set up in the treasury and in the tax and customs services, a new criminal code was adopted, and a program of dissemination of laws and regulations was put in place. However, much more remains to be done to deal with corruption, particularly in customs and the judiciary.

ARMENIA: RELATIONS WITH THE FUND
(As of September 30, 2004)

I. Membership Status: Joined 05/28/1992; Article VIII

	SDR Million	Percent of Quota
II. General Resources Account	**SDR Million**	**Percent of Quota**
Quota	92.00	100.00
Fund holdings of currency	96.22	104.59
III. SDR Department	**SDR Million**	**Percent of Allocation**
Holdings	7.32	n.a.
IV. Outstanding Purchases and Loans	**SDR Million**	**Percent of Quota**
PRGF arrangements	135.20	146.95
Systemic transformation	4.22	4.59

V. Latest Financial Arrangements

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	05/23/2001	12/31/2004	69.00	60.00
ESAF/PRGF	02/14/1996	12/20/1999	109.35	109.35
SBA	06/28/1995	02/14/1996	43.88	13.50

VI. Projected Obligations to Fund (SDR Million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	8.28	23.28	21.18	15.43	17.06
Charges/interest	0.37	0.64	0.50	0.40	0.32
Total	8.65	23.92	21.68	15.83	17.38

VII. Safeguards Assessment

Under the Fund's safeguards assessment policy, the Central Bank of Armenia (CBA) is subject to a full safeguards assessment with respect to the PRGF arrangement approved on May 23, 2001. The safeguards assessment of the CBA, completed on February 19, 2002, found the safeguards at the CBA to be generally adequate to ensure the integrity of bank resources, including Fund disbursements. However, the assessment noted a number of vulnerabilities and proposed specific measures to address the weaknesses. The CBA has implemented all the measures recommended.

VIII. Exchange Rate Arrangement

(a) On November 22, 1993, the Republic of Armenia introduced its national currency, the dram, at a rate of 200 Armenian rubles per dram. The exchange rate has been allowed to float since then with minimal intervention by the central bank. The official exchange rate is quoted daily as a weighted average of the previous day's interbank exchange rates.

(b) Armenia maintains no exchange restrictions on the making of payments and transfers for current international transactions except for exchange restrictions maintained for security reasons, and notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

IX. Article IV Consultations

The 2002 Article IV consultation with Armenia was concluded on September 25, 2002. Armenia is subject to the 24-month consultation cycle.

X. FSAP Participation and ROSCs

A joint World Bank-International Monetary Fund mission assessed Armenia's financial sector as part of the Financial Sector Assessment Program (FSAP) during September 6–22, 2000. The Financial Sector Stability Assessment (FSSA) report was discussed at the Board on May 14, 2001, together with the 2001 Article IV staff report. The authorities have made progress in implementing the FSAP recommendations. Outstanding issues that need to be addressed include several legislative and regulatory shortfalls and the need for enactment of the legal protection for supervisory authorities. An FSAP update is scheduled to be conducted during this financial year.

ROSC Modules

Standard	Timing	Issue Date	Document Number
Basel Core Principles for Effective Banking Supervision (BCP)	April 2001	Unpublished	…
Core Principles for Systemically Important Payments Systems (CPSS)	April 2001	Unpublished	…
Insurance Principles set by the International Association of Insurance Supervisors (IAIS)	2001	Unpublished	…
Principles set by the International Organization of Securities Commissions (IOSCO)	2001	Unpublished	…
Code of Good Practices in Monetary and Financial Policy Transparency (MFPT)	April 2001	Unpublished	…
Code of Good Practices on Fiscal Transparency	March 2001	Published	02/37
Data ROSC module	September 2000	Published	02/06

XI. Resident Representatives

Mr. James McHugh, since September 2002.

XII. Technical Assistance

The following table summarizes the Fund's technical assistance to Armenia since 1998.

Armenia: Technical Assistance from the Fund, 1998–2003

Subject	Type of Mission	Timing	Counterpart
Fiscal Affairs Department (FAD)			
Development of treasury	Resident Advisor	Since September 1998	Ministry of Finance and Economy (MFE)
Tax policy	Short-term	March 1–12, 1999	MFE and Ministry of Nature Protection
Tax administration mission	Short-term	February 28–March 13, 2000	MFE and Ministry of State Revenue (MSR)
Tax policy and administration	Short-term	August 7–11, 2000	MFE and MSR
Tax policy and administration	Short-term	October 15–29, 2001	MFE, MSR, and Customs Committee
Tax policy and administration	Short-term	September 17–October 3, 2003	MFE, State Tax Service (STS), and Customs Committee
Tax policy	Short-term	April 22–May 6, 2004	MFE, STS, and Customs Committee
Tax administration	Short-term	July 13–July 27, 2004	MFE, STS, and Customs Committee
Monetary and Exchange Affairs Department			
Monetary and foreign exchange operations	Resident Advisor	November 1997–November 1998	Central Bank of Armenia (CBA)
Banking supervision	Short-term	Periodic visits 1998–99	CBA
Monetary and foreign exchange operations	Short-term	January 20–February 3, 1998	CBA
Monetary policy; OPS/BKG sector issues	Short-term	November 9–13, 1998	CBA
Monetary operations and banking supervision	Short-term	February 21–March 5, 1999	CBA
Monetary operations	Short-term	Periodic visits 1999–2000	CBA
Banking supervision	Resident Advisor	April 2000–December 2002	CBA
Monetary policy research	Short-term	April 28–May 4, 2000	CBA
Financial sector assessment program	Short-term	September 5–22, 2000	CBA
Monetary operations, monetary policy research and banking supervision	Short-term	September 3–14, 2001	CBA
Banking system issues	Short-term	April 15–19, 2002	CBA
Banking system, deposit insurance, foreign exchange market development, and CBA monetary operations.	Short-term	June 24–July 4, 2002	CBA
Unified financial supervision, mortgage financing markets and inflation targeting	Short-term	January 26–February 6, 2004	CBA
Statistics Department			
Multisector	Short-term	October 26–November 11, 1998	MFE, CBA, Ministry of Statistics
National accounts statistics	Short-term	August 3–16, 1999	Ministry of Statistics
Balance of payments statistics	Short-term	September 7–October 4, 1999	Ministry of Statistics
Data dissemination standards	Short-term	August 29–September 11, 2000	National Statistical Service
Data dissemination standards	Short-term	September 18–25, 2003	National Statistical Service

ARMENIA: RELATIONS WITH THE WORLD BANK
(As of October 13, 2004)

Country Director: Donna Dowsett-Coirolo Telephone: (202) 473-0121

I. Implementation of Structural Reform Measures

A. Legal Framework

The Armenian government has established the core legal framework necessary for private sector operations, including the Civil Procedure Code, the Procurement law, the Business Registration law and the Public Auction law. The fully restructured and enacted Bankruptcy law is now harmonized with the Civil Code and the Civil Procedure Code, and strengthens the enforcement mechanisms for bankruptcy procedures. The Concession law has been enacted and the National Assembly has adopted a new Labor Code, which is compatible with the requirements of a market economy and is an important instrument of flexible job-creation.

B. Business Environment

The government has made satisfactory progress in removing administrative barriers for business and investment and has strengthened the consultative mechanisms with the business community. The steps taken include, inter alia, consolidating, downsizing, and clarifying mandates of various government inspections; enacting the new law on business registration; streamlining licensing procedures; issuing new accounting recommendations for small and medium-sized enterprises; establishing a regulatory framework that allows privatization of urban land by business entities; and adopting simplified procedures for obtaining site development and construction permits. The capacity of the Armenian Development Agency as a focal point for government's efforts to promote investment and exports as well as for identifying the remaining bottlenecks in the business environment has been strengthened. The functioning of the Business Council has been improved and the private sector's awareness of its activities has been enhanced.

The recent business surveys of the Armenian entrepreneurs during 2002 and 2003, suggest that these efforts have already resulted in a more positive private sector perception of the business and investment environment. For example, the average time necessary to get construction and building renovation permits was reduced from 310 days in 2001 to 76 days in 2003. The number of goods subject to mandatory certification at the border was reduced from 80 in 2001 to 60 in 2003. The number of registered joint ventures increased by 25 percent from January 1, 2002 to November 1, 2003, and the FDI (outside the energy sector) increased by 44 percent in the first nine months of 2003 compared with a similar period in 2002. The State Customs Committee's websites became operational and during 2003, on average 467 references per month were made to it. Despite these improvements, there is still considerable scope for further reforms in the areas of competition, deregulation and strengthening of business and investment climate, especially in commercial debt recovery procedures, improvements in the transparency and efficiency of the judicial system, tax and customs administrations, improvements in governance and implementing the anti-corruption strategy.

C. Energy and Infrastructure

Since its privatization in the second half of 2002, the Electricity Distribution Company has remained in compliance with its licenses agreement as confirmed by making full payments to the generation and service providers, reporting to the regulator on a timely basis, and submitting investment plan to the regulator. The government has also made satisfactory efforts to improve the legal and regulatory framework in the energy sector in order to establish a supportive environment for the new private operator. Budget allocations have been increased to ensure full payments to the energy sector by the budgetary organizations and public utilities. Despite this satisfactory performance, continued efforts are crucial for improvements in the energy sector through restructuring the midstream companies and strengthening the regulatory framework to ensure adequate functioning, transparency, and reliability of this sector.

There has been limited progress in improving fiscal discipline and reducing losses in the irrigation and water sectors. The World Bank has been working with the government to: (i) upgrade the management capacity of public companies in these sectors; (ii) ensure a gradual increase in tariffs to cost recovery; (iii) provide additional investments to improve technical efficiency; and (iv) ensure that the budget provides adequate financing for water consumed by public sector entities. The government has adopted the medium-term Infrastructure Rehabilitation Plan to provide further guidelines for restructuring in water, irrigation, and public transportation. To provide full cost recovery, the government has adopted a schedule for irrigation tariff increase in 2002–07 in order to achieve full cost recovery in the irrigation system by 2007.

E. Education and Health

The government implemented a major rationalization program during the 2003 school year. As a result, 37 schools were merged or closed and about 3,500 teachers were made redundant. The medium-term action plan for improving the financial management, accounting, and financial reporting for higher education institutions was adopted by the government on January 26, 2003. Accountants at the higher institutions have been trained and special software has been prepared for use. Since the second quarter of 2003, the new accounting procedures are being used. The government increased the state budget allocation for primary and secondary education and improved teachers' salaries. The government also developed an action plan and cleared arrears in the education sector and prevented further arrears in this sector. Despite these improvements, there is scope for further reforms in education, including adoption of new curricula for secondary education, enhancement of standards for higher education to make it more responsive to employers' needs, improving preschool systems, and strengthening monitoring and financial reporting of the noncommercial organizations (NCOs) in the education sector.

The government adopted the hospital master plan for Yerevan in late 2002. As a result, the remaining public hospitals in Yerevan were to be merged into smaller number of hospital networks with necessary steps to be taken to restructure them. The government adopted a decree on November 21, 2003, identifying the configuration of ten hospital networks through consolidation of twenty-four public hospitals and thirteen outpatient health care institutions. Directors for nine of these hospital networks have been appointed. While the hospital merger process is being implemented, introduction of further appropriate adjustments may be required. The medium-term action plan for improving financial management accounting and reporting for the public hospitals was adopted by the government on September 14, 2003, to prepare new reporting and accounting procedures and cost accounting manuals.

Implementation progress has been satisfactory and about 200 hospital accountants have been trained in new accounting procedures. The government developed an action plan for clearing the accumulated arrears in the health sector and prevented further arrears in this sector. The government also adopted a Decision to introduce further reforms in the Basic Benefit Package in the health sector. Further reforms are needed in increasing the population overall health status, reducing child and maternal mortality, increasing use of healthcare system by rural and low-income groups, monitoring public health and promoting better health behavior, and strengthening monitoring and financial reporting of the noncommercial organizations (NCOs) in the health sector.

F. Social Protection and Insurance

Since 1999, the government has been replacing a range of fragmented cash and non-cash benefits and privileges with better-targeted transfers to families. The government completed several important steps to enhance its capacity for administration of transfers to families, including: (i) re-registration of poverty benefit recipients; (ii) beneficiary assessment of the existing benefits; and (iii) establishment of a central database for poverty benefit recipients. Data from the recent household survey suggest that the system of benefits and transfers to the poor has become an efficient instrument for reducing extreme poverty. Continued efforts are needed to ensure the adequacy of the level and administrative capacity of the social protection systems to guarantee coverage of transfers to people with special needs.

The law on Public Pension focuses on strengthening and streamlining the pension system. It provides significant improvements in the pension systems, including: (i) introduction of an equal retirement age for men and women at age 63; (ii) separation of social insurance benefits from social pensions; (iii) elimination of most early retirement provisions; (iv) indexation of pension to inflation; and (v) establishment of more direct links between benefits and contributions, with adequate provision for a minimum benefit. Following adoption of the law, the government has made satisfactory progress in its implementation. The government decree no. 309 of July 2003, established an inter agency working group to monitor introduction of the Personal Identification Numbers (PINs) into the pension system. Additionally, a range of necessary implementation regulations, based on the Public Pension Law, was developed, including: (i) the documents required for award of pensions; (ii) rules for awarding and making payments for partial pensions to those with less than the minimum required length of insurance history; (iii) procedures for making payments of the survivors' pensions to children under full state custody; and (iv) procedures for awarding, computing and making payments of the privileged pensions. While the fiscal performance of the Sate Pension Fund has improved and as a result, the average pension has increased, the level, coverage and sustainability of pensions are issues for further elaboration.

II. Lending

World Bank lending to Armenia as of October 13, 2004 totals US$822.1 million, of which US$672.6 million has been disbursed. Of the 36 IDA credits and 1 IBRD loan approved, 17 have closed.

Building on the major Poverty Reduction Strategy Paper (PRSP)'s themes, the fourth Country Assistance Strategy (CAS) for Armenia was discussed in the World Bank Board of Executive Directors on June 10, 2004 to focus on three main objectives of: (i) promoting private sector led economic growth, (ii) making growth more pro-poor, and (iii) reducing non-income poverty. Unless the high case is reached, IDA lending is expected to be up to $45 million a year during the forthcoming CAS period and could reach up to $55 million a year if Armenia moves into the high case during the FY05–08 CAS period. Towards the end of the CAS period, there could be a first IBRD loan if Armenia's creditworthiness improves sufficiently. The CAS includes three Poverty Reduction Support Credits (PRSCs) for FY05, 06 and 07. These will support the PRSP objectives and focus on four critical reform themes: (i) consolidating macroeconomic discipline and strengthening governance, (ii) sharpening competition and entrenching property rights, (iii) mitigating social and environment risk, and (iv) modernizing the rural economy. Macroeconomic stability is a precondition for the PRSC and is vital for facilitating an enabling environment necessary for successful structural reforms implementation. The PRSC's preparation is being closely coordinated with the IMF Poverty Reduction and Growth Facility (PRGF). The first proposed PRSC is expected to be presented to the World Bank Board of Executive Directors on November 18, 2004.

List of World Bank Lending to Armenia
(In millions of U.S. dollars)

	Active Projects	Credit Amount as of 10/13/04	Disbursement as of 10/13/04	Approval Date	Closing Date
Active Projects		*296.8*	*153.8*		
1.	Agric. reform support	14.5	14.3	01/27/98	06/30/05
2.	Municipal development	30.0	26.5	06/11/98	04/30/05
3.	Title registration	8.0	7.6	10/13/98	09/30/04
4.	Electric. trans. & dist.	21.0	14.9	03/04/99	12/31/04
5.	Irrigation dam safety	26.6	17.3	06/24/99	03/31/05
6.	Transport	40.0	37.3	06/08/00	12/31/04
7.	Social Investment Fund II	20.0	14.2	05/11/00	12/31/05
8.	Judicial reform	11.4	5.0	09/14/00	06/30/06
9.	Irrigation development	24.9	10.5	08/30/01	03/31/07
10.	Enterprise incubator	5.0	1.4	11/30/01	06/30/05
11.	Investment and export facilitation	1.0	0.5	04/16/02	12/31/05
12.	Natural resource management	8.3	1.9	06/04/02	07/31/08
13.	Municipal water and WW	23.0	0.0	05/04/04	02/28/09
14.	Educ. Qual. & Relevance (APL # 1)	19.0	1.7	01/20/04	11/30/08
15.	Urban Heat	1.0	0.3	01/23/03	05/31/05
16.	Yerevan Water/WW Services	2.0	0.4	12/08/03	02/28/05
17.	Health System Mod.	19.0	0.0	06/10/04	06/30/09
18.	Social Protection Admi.	5.2	0.0	06/10/04	12/31/07
19.	Irrigation Dam Safety 2	6.8	0.0	06/10/04	03/31/09
20.	Public Sector Mod.	10.1	0.0	05/04/04	03/31/09
Completed Projects		*525.3*	*518.8*		
21.	Irrigation rehabilitation	43.0	40.9	12/08/94	05/31/01
22.	Highway	31.0	29.5	09/14/95	12/31/00
23.	Social Investment Fund	12.0	11.1	11/09/95	12/31/00
24.	Institution building	12.0	10.7	03/30/93	11/30/97
25	Earthquake rehabilitation	28.0	29.7	02/01/94	06/30/97
26.	Power maintenance	13.7	13.2	12/08/94	06/30/99
27.	Economic rehabilitation	60.0	64.3	02/28/95	06/30/96
28.	SAC	60.0	58.5	02/29/96	12/31/97
29.	SAC II	60.0	58.6	08/26/97	06/30/99
30.	SATAC I	3.8	2.8	02/29/96	06/30/00
31.	SAC III	65.0	63.4	12/22/98	06/30/01
32.	Enterprise development	16.8	15.3	12/24/96	07/01/02
33.	SATAC II	5.0	4.7	08/26/97	12/31/02
34.	Education	15.0	14.6	11/20/97	10/31/02
35.	SAC IV	50.0	49.4	05/22/01	03/31/03
36.	SAC V	40.0	42.8	03/13/03	06/30/04
37.	Health	10.0	9.3	07/29/97	12/30/03
	Total	822.1	672.6		

ARMENIA: RELATIONS WITH THE EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT (EBRD)

(As of October 1, 2004)

As of October 1, 2004, EBRD had signed twelve projects in the power, transport, agribusiness, mining and financial sectors. Total cumulative commitments amounted to EUR 93.5 million.

There are two sovereign projects. First, the EBRD approved a sovereign guaranteed loan of EUR 54.8 million for construction of the Hrazdan Unit 5 thermal power plant in March 1993, partly aimed at the eventual closure of Armenia's nuclear plant in Medzamor. The government is contemplating the privatization of Hrazdan Unit 5 as the completion of this plant is constrained by limited budgetary resources. The EBRD had funded technical assistance for the Hrazdan privatization prospectus and continues to follow the privatization process. The Hrazdan Thermal Power Complex excluding the unfinished Unit 5 has been transferred to the Russian Federation in the context of the debt-for-equity deal. Second, in November 1994, the agreement on a EUR 21.8 million loan to build an air cargo terminal in Zvartnots airport was signed under a guarantee by the Armenian government. The airport was transferred to private management in 2002. The new management has prepared a master plan for the development of the airport, which is expected to generate further cargo traffic for the cargo terminal.

There have also been a number of private sector projects in Armenia. The EBRD has provided a loan to the Yerevan Brandy Company owned by Pernod Ricard of France (EUR 19.1 million). In the banking sector, an equity participation in the Commercial Bank of Greece-Armenia (EUR 1.1 million) was approved in late 1999. Moreover, a multi-bank on-lending facility of EUR 10 million was activated in early 2000. Within the framework of multi-bank facility the Bank currently has credit lines for micro and small enterprises with three local banks (a total of EUR 4 million). The EBRD is committed to further expanding lending under this facility to other banks. A Trade Facilitation Program with the purpose to facilitate access of Armenian banks to trade financing was also made available to four Armenian banks. In 2002 a loan to finance EUR 2.9 million in working capital expansion was signed with the Armenian Copper Programme (the only copper smelter in the region) and a new loan (EUR 4.3 million), including the refinancing of the existing loan, was signed in August 2004. Moreover, the EBRD has launched the Turn Around Management (TAM) and Business Advisory Service Programmes in Armenia in 2003, funded by the EU-Tacis program, to support micro, small and medium-sized enterprises.

The key priorities of the EBRD for the coming years are (i) enterprise sector, (ii) financial sector, (iii) portfolio monitoring and implementation support and (iv) infrastructure and state-owned public utilities. The EBRD's new country strategy was approved in November 2003.

ARMENIA: STATISTICAL ISSUES

The overall quality, timeliness, and coverage of macroeconomic statistics in Armenia have improved significantly over the past few years, a process in which the Fund has been heavily involved through technical assistance from the Statistics Department, the Fiscal Affairs Department, and the Monetary and Exchange Affairs Department. On November 7, 2003 Armenia subscribed to the Special Data Dissemination Standard (SDDS) and has provided timely data for all SDDS prescribed data categories. Further improvements are needed in real, fiscal, and external sector statistics in order to enhance the design and monitoring of economic policies. The table below on core statistical indicators shows the availability of key macroeconomic data and the authorities' publication policy.

National accounts and price statistics. The National Statistics Service has made significant changes to the national accounts methodology to bring it in line with international best practices. Progress has been made in developing estimates of quarterly real GDP that are now published. Basic data collection procedures have also improved, with national accounts adopting the concept of gross value based on accrued sales valued at transaction prices. However, progress has been slow in improving the compilation of national accounts at constant prices; these data are still derived by re-valuing current output and inputs at previous year prices instead of deflating these by the relevant components of the producer price index. Data on the consumer price index and wages are reported on a timely basis, but wage data are still limited to the public sector.

Fiscal statistics. The budget execution reporting system is compiled on a cash-basis and supplemented with monthly reports on arrears and quarterly reports on receivables and payables. However, the system to track arrears is cumbersome and there is a 45-day lag in the compilation of the data. Daily revenue and cash expenditure data for the central government are available with a lag of one to two days. The Ministry of Finance is undertaking a comprehensive reform of the treasury system, including the introduction of an internal auditing system in line ministries and their budgetary institutions. A single treasury account (TSA) was introduced in 1996, and all bank accounts held by budgetary institutions were closed, except for Project Implementation Units that are required by donors to operate with commercial banks' accounts. Starting in 2002, some budgetary institutions have been converted into "noncommercial organizations" (NCOs). These units have been taken out of the treasury system and have their own bank accounts. They have just started reporting data on their operations to the Ministry of Finance. With these exceptions, all government receipts and payments are processed through the TSA, although there are still shortcomings on the timeliness and quality of data on the operations of local governments. Classification of government transactions by function and economic category are generally in line with the Manual on Government Finance Statistics 1986, and monthly data on central government operations are disseminated within 40 days of the end of the month. However, the budget presentation and the classification of items under the economic and functional classification of expenditures need to be made more transparent; for instance, the data has been subject to frequent reclassifications and wages for military personnel are reported in the broader category of "other" goods and services rather than as a wage item. The reconciliation of central government with general government operations is also difficult owing to the need to identify manually transactions among central government, local government, and the Social Insurance State Fund. The authorities expect by early 2005 to begin providing date for publication in the *GFS Yearbook* or in the *IFS* in early 2005.

Money and banking statistics. Money and banking statistics are provided on a timely basis. Daily data on the accounts of the CBA are provided weekly with a one-day lag, while weekly data on the monetary survey are provided with a one-week lag. Monthly interest rate data are provided with an one-week lag. A new chart of accounts meeting International Accounting Standards (IAS) was introduced in January 1998. Since then, the balance sheets of the CBA and of the deposit money banks follow IAS methodology.

External sector statistics. The coverage of external sector data has improved in recent years. Trade statistics are provided on a timely basis, and trade data by origin or destination and by commodity are generally available within a month. Price data for exports and imports is less readily available. Quarterly balance of payment data are generally available with a three-month lag. However, data on private non-guaranteed external debt and on direct investment abroad are not compiled, and capital outflows are likely underestimated. The balance of payments data will need to be revised in light of recent studies showing that remittance inflows have been underestimated. The absence of a fully established (comprehensive and updated) business register in Armenia hampers a wider coverage of transactions and institutional units. The international investment position for 1997–2003 has been compiled and published.

Armenia: Core Statistical Indicators
(As of November 4, 2004)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Monetary Survey	Interest Rates	Consumer Price Index	Exports/ Imports	Balance of Payments	Central Government Balance	GDP	External Debt
Date of latest observation	10/29/04	10/28/04	10/28/04	09/30/04	10/24/04	October 2004	August 2004	Q2 2004	September 2004	September 2004	Q3 2004
Date received	11/02/04	11/02/04	11/02/04	11/02/04	11/02/04	10/29/04	10/15/04	10/20/04	11/04/04	10/30/04	10/30/04
Frequency of data	Daily	Daily	Daily	Monthly	Weekly	Monthly	Monthly	Quarterly	Monthly	Monthly	Quarterly
Frequency of reporting	Weekly	Weekly	Weekly	Weekly	Weekly	Monthly	Monthly	Quarterly	Monthly	Monthly	Quarterly
Source of update	CBA	CBA	CBA	CBA	CBA	NSS	NSS	NSS	MFE	NSS	MFE
Mode of reporting	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of publication	Daily	Quarterly	Quarterly	Monthly	Monthly	Monthly	Monthly	Annually	Monthly	Quarterly	Annually

Abbreviations: CBA (Central Bank of Armenia), MFE (Ministry of Finance and Economy), NSS (National Statistics Service).

Statement by the IMF Staff Representative
December 1, 2004

1. The following information has become available since the issuance of the staff report on November 17. It does not change the thrust of the staff appraisal.

2. Recent data on monetary aggregates, inflation, and the exchange rate have been in line with expectations. By end-October, the annual growth of reserve money and broad money was 12 and 22 percent, respectively. The 12-month rate of inflation in November was 4.8 percent, down from 6.1 percent in September. The exchange rate has remained broadly stable since September, trading in a range of 496 to 508 drams per U.S. dollar.

3. After a series of delays, parliament approved on November 22 the law on trade and services and the law on cash registers. This was a structural benchmark under the fifth review of the program. These laws expand the tax base to large retail markets and are expected to become effective in January.

4. As noted in the staff report, the last intervened bank (Armcommunications bank) was recapitalized by a new investor in October. The authorities have informed the staff that the investor has acquired both the bank and the chemical company Nairit (the bank's main debtor) and is expected to either sell or swap shares of Nairit with interested parties or depositors. However, the market value of Nairit is uncertain, raising questions about the bank's solvency. The staff has advised the authorities to ensure that the bank complies with prudential norms.

5. Last week, parliament approved the first reading of a bill amending the country's anti-money laundering and terrorist financing legislation. The amendments include procedures for investigating suspicious transactions and creating a Financial Intelligence Unit at the central bank. The bill had been initially rejected as some legislators expressed concerns about the treatment of worker's remittances.

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Washington, D. C. 20431 USA

IMF Executive Board Concludes Article IV Consultation with the Republic of Armenia

On December 1, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Armenia.[1]

Background

Armenia's economy has performed well during the last three years. Annual real GDP growth averaged 12 percent between 2001 and 2003. Fiscal and quasi-fiscal deficits were significantly reduced and inflation remained in single digits. The external current account deficit fell rapidly in response to strong export growth stemming from increased competitiveness as well as import substitution. Poverty, while still high, fell about 8 percentage points to an estimated 43 percent of the population.

Armenia's strong economic performance has been continuing in 2004. In the period January–September, the year-on-year rate of GDP growth was 10 percent, fueled by increases in agricultural production, housing construction, and services. GDP growth for the year as a whole is projected to be 9 percent. The 12-month rate of inflation fell from 8.6 percent in December 2003 to 6.1 percent in September. The central bank's inflation objective of 3 percent for 2004 is within reach, but may be exceeded slightly because of recent increases in fuel prices.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

On fiscal policy, tax revenues through September 2004 increased by 21 percent over the same period last year. The fiscal deficit in 2004 is projected at 1.1 percent of GDP because of under-execution of expenditures mainly due to capacity constraints. The 2005 budget is expected to target a fiscal deficit of about 2 percent of GDP and will accommodate higher social and infrastructure spending in line with Poverty Reduction Strategy Paper priorities, while rationalizing nonpriority current expenditures. The projected deficit is consistent with macroeconomic stability.

Regarding monetary policy, broad money and private sector credit grew by 20 percent and 43 percent in the year through September respectively. In 2004, reserve money and broad money are projected to grow at about 4 percent and 15 percent, respectively.

Since mid-2003, banking sector performance has improved and there has been a gradual return of confidence toward banks following the resolution of eight intervened banks. While interest rates have continued their gradual declining trend, dollarization remains at over 70 percent.

After a slight deterioration in 2003, the external current account deficit is expected to narrow to 5.6 percent of GDP in 2004 because of higher workers' remittances. Despite lower capital grants, the capital and financial account remain well supported by continued increases in foreign investment. Gross international reserves are expected to remain slightly below four months of imports. External debt ratios are projected to decline further in 2004–05. The recent real exchange rate appreciation has helped to mitigate the effect of recent hikes in the prices of imported fuels on inflation and on real incomes. The appreciation only partially compensates for a more than 25 percent real depreciation between 2000 and 2003.

The structural reform agenda has progressed during the last two years, although there have been a number of delays. There was good progress in strengthening expenditure control, reducing red tape, and improving efficiency in the energy and water sectors. Notwithstanding these achievements, there is a need for further deepening of structural reforms to revamp tax and customs administration, strengthen the financial system and the judiciary, improve expenditure management, and increase efficiency in the water and irrigations sectors. To tackle corruption in the public sector, the implementation of the recently prepared anti-corruption strategy needs to be stepped up, especially regarding the development of an independent judicial system.

Executive Board Assessment

Executive Directors commended the Armenian authorities for remarkable progress made, particularly in recent years, to consolidate macroeconomic stability and build the foundations for a modern market economy. Prudent economic policies and structural reforms have contributed to double-digit growth, poverty reduction, low inflation, and a sustainable debt burden. Notwithstanding these achievements, Directors noted that some structural reforms had suffered from delays or incomplete implementation, and that important challenges remain to sustain high rates of economic growth and reduce poverty further.

Directors endorsed the current stance of monetary policy aimed at lowering annual inflation to 3 percent. They agreed that the planned deepening of the government debt market would facilitate monetary management and private debt issues. While welcoming the recent increase in credit to the private sector, Directors underscored the importance of monitoring closely the quality of loan portfolios and potential foreign exchange risks as part of the steps to strengthen banking supervision. Directors also noted that further efforts are needed to increase financial intermediation, including enhancing corporate governance in banks, streamlining collateral recovery procedures, and improving court processes. They looked forward to the recommendations of the forthcoming Financial Sector Assessment Program mission. Approval by parliament of the anti-money laundering and financing of terrorism legislation, and its implementation would also be important.

Directors considered that the flexible exchange rate regime has served Armenia well, facilitating the conduct of monetary policy and helping the economy to adjust to external shocks. They noted that the recent appreciation of the dram has helped offset the impact of higher import prices on inflation, while competitiveness has been safeguarded by productivity gains since 2001.

Directors welcomed the progress made in reducing fiscal imbalances in recent years. They looked forward to a cautious fiscal stance in 2005 and an expenditure envelope in line with PRSP priorities on social and infrastructure spending. Directors also welcomed the planned increases in social spending in the 2005 budget, but emphasized the importance of capacity building and transparency in state-owned noncommercial organizations to ensure the efficient provision of social services. At the same time, a balanced mix of current and capital expenditures will be critical to sustain the high trajectory of growth. This will require higher allocations to capital expenditures in the transport, agriculture, and water sectors. In this regard, Directors encouraged the authorities to formulate a medium-term public investment program to define and prioritize public investment and poverty reduction needs as well as guide future external assistance.

On the revenue side, Directors generally expressed disappointment that, despite high growth in nominal tax revenues in recent years, the tax effort has not increased. In this regard, Directors noted that remaining deficiencies and discretion in tax and customs administration are one of the key barriers to higher tax collection, and urged the authorities to make wide use of improved systems for collection, VAT refunds, and customs clearance. This would yield the higher tax revenues that are needed to maintain fiscal sustainability and finance rising levels of pro-poor spending. Directors also endorsed the staff's proposals to revamp the organizational structure of the tax and customs agencies and bring them under the umbrella of the Ministry of Finance.

The authorities should be commended for the progress made in the energy sector in recent years. Notwithstanding these achievements, Directors underscored the importance of completing reforms in this sector and advancing the reform agenda in the water and irrigation sectors, including through bringing tariffs toward cost-recovery levels.

Directors noted that governance and the business environment have improved in recent years, but that more remains to be done to reduce red tape, increase accountability in the public sector, and combat corruption. To this end, they urged the authorities to avoid complacency and press ahead with the implementation of the anti-corruption strategy in consultation with civil society. Regarding the PRSP, Directors welcomed the recent establishment of monitoring indicators and looked forward to the forthcoming progress report on its implementation.

Directors welcomed the opportunity to review the ex post assessment of Armenia's long-term program engagement. They agreed that Fund involvement has been effective in promoting sound economic policies and reforms. While recognizing that much has been achieved during the last 10 years, Directors noted that a stronger political commitment would be needed to address remaining problems in tax and customs administration, the banking system, and to improve governance. In the context of such a demonstrated commitment, Directors considered that a new arrangement with the Fund could play a valuable role in facilitating consensus on appropriate policies and providing confidence to donors and investors.

Republic of Armenia: Selected Economic Indicators, 19992004

	2000	2001	2002	2003	2004 Proj.
Real Sector					
Real GDP growth (percent change)	6.0	9.6	13.2	13.9	9.0
GDP (in millions of U.S. dollars)	1,912	2,120	2,373	2,805	3,408
GNI per capita	598	680	767	902	1,090
Inflation (in percent)					
Period average	-0.8	3.1	1.1	4.8	6.3
End-of-period	0.4	2.9	2.0	8.6	3.0
Central government operations (in percent of GDP)					
Revenue and grants	16.5	17.0	18.8	17.8	15.7
Expenditure	22.9	20.9	19.3	18.9	17.0
Overall balance (commitment basis)	-6.4	-3.8	-0.4	-1.1	-1.3
Monetary Indicators					
Reserve money (end-of-period growth rate, in percent)	34.4	11.1	38.4	6.6	4.2
Broad money (end-of-period growth rate, in percent)	38.6	4.3	34.0	10.4	15.0
Broad money velocity	6.9	7.4	6.4	6.9	6.8
External Sector					
Current account balance (including transfers)					
In millions of U.S. dollars	-278	-200	-148	-191	-188
In percent of GDP	-14.6	-9.5	-6.2	-6.8	-5.6
External debt					
In millions of U.S. dollars	862	906	1,026	1,098	1,109
In percent of exports of goods and services	139	132	131	87	73
Gross official international reserves (in millions of U.S. dollars)	314	329	430	502	507
In months of imports of goods and services	3.6	3.6	3.7	4.0	3.7

Sources: Armenian authorities; and IMF staff estimates.

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IMF Executive Board Completes Final Review Under PRGF Arrangement for the Republic of Armenia

The Executive Board of the International Monetary Fund (IMF) today completed the sixth and final review of the Republic of Armenia's economic performance under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement. The completion of this review enables Armenia to draw an amount equivalent to SDR 9.0 million (about US$13.7 million).

In completing the final review, the Executive Board also approved Armenia's request for a waiver of two structural performance criteria.

At the time of the fifth review on May 3, 2004 the period of the arrangement was extended through December 31, 2004 (see Press Release No. 04/90). Armenia's PRGF arrangement was initially approved with effect from May 23, 2001 (see Press Release No. 01/25) for an amount equivalent to SDR 69 million (about US$105.3 million). With the completion of the sixth review, the arrangement will be fully disbursed. The authorities have also stated their intention to begin discussions with the IMF on a new three-year PRGF arrangement that would support an economic program through 2008.

Following the Executive Board's discussion of Armenia's performance under the current PRGF-supported program, Agustín Carstens, Deputy Managing Director and Acting Chair, said:

"The Armenian authorities should be commended for Armenia's strong economic performance in recent years, in the context of satisfactory implementation of the PRGF-supported program. Prudent monetary and fiscal policies, external financial support, and progress with structural reforms have contributed to double-digit economic growth, poverty reduction, low inflation, and a sustainable debt burden.

"Looking ahead, the authorities should maintain a cautious fiscal stance and ensure that the expenditure envelope is in line with PRSP priorities on social and infrastructure spending. Monetary policy should remain tight while maintaining a flexible exchange rate regime in order to bring inflation down to the authorities' objective of 3 percent. To facilitate further financial intermediation, reforms are needed to enhance corporate governance in banks, streamline collateral recovery procedures, and improve court processes.

“Notwithstanding the progress made in recent years, the authorities need to tackle more forcefully the remaining deficiencies and reduce discretion in tax and customs administration. This will contribute to an improved business environment and yield higher tax revenues to finance pro-poor spending. On the expenditure side, a balanced mix between current and capital spending will be critical to sustain the high trajectory of growth. This will require higher allocations to capital expenditures in the transport, agriculture, and water sectors. At the same time, the envisaged increases in social spending highlight the importance of ensuring that they will be utilized efficiently and transparently.

“The authorities should be commended for the improvement in the energy sector in recent years. Looking ahead, the authorities need to complete the reform agenda in this sector and step up the implementation of reforms in the water and irrigation sectors, including through an increase in tariffs to cost recovery levels.

“Armenia’s medium-term prospects are likely to remain favorable provided the authorities move ahead with the implementation of the reform agenda and redouble their efforts to improve governance,” Mr. Carstens stated.

The PRGF is the IMF’s concessional facility for low-income countries. PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a Poverty Reduction Strategy Paper, or PRSP. This is intended to ensure that each PRGF-supported program is consistent with a comprehensive framework for macroeconomic, structural, and social policies, to foster growth and reduction poverty. PRGF loans carry an annual interest rate of 0.5 percent, and are repayable over 10 years with a 5 ½-year grace period on principal payments.